

Auto Financing Update

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Generic Bureau Scores and Indirect Lending - Some Important New Issues

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The use of credit bureau-based generic risk scores has developed into an industry standard in indirect lending over the past 8 years, particularly vehicle lending and leasing. Lenders of all sizes are familiar with the variety of these scores, and their use in risk-based pricing, setting loan amounts, and making accept/decline decisions.

A number of different generic bureau scores are available from all three consumer credit bureaus. They have played an important role in the growth of consumer credit and the expansion of automotive lending in the US. However, the proliferation of these scores has made risk management more complex. Some lenders may not be familiar with all the nuances of using these scores. The purpose of this article is to discuss some important new issues that we have encountered with our clients over the past year in the use of generic bureau scores and suggest preliminary means of addressing them.

Issue One - Multiple versions of the same score (i.e., stale scores) are available from the credit bureaus. Over the years, new versions of generic credit scores have been released, providing increasingly more powerful risk management tools. A recognized leading developer of these scores, Fair, Isaac and Co., Inc, for example, regularly releases updated versions of its risk scores to all of the bureaus, and other developers do the same. However, some lenders over time, possibly in the misguided attempt to avoid changing their lending strategies or because of their comfort with the older scores, asked the bureaus to continue offering "old" versions even after the new versions became available. This has resulted in a situation where at least two of the bureaus are currently vending multiple versions of the same score.

For example, assume that one generic bureau credit score was developed in 1995 using data that went back to 1993, and the most recent development was conducted in 1997 using data from 1995. The scores based upon the more recent development will be the sharper analytic tool, and will be better able to distinguish high quality applicants from riskier ones. To use an analogy, choosing an "old" scoring product is similar to wearing an old pair of eyeglasses instead of a new pair. You will still be able to see, but the image will not be as sharp as you would prefer. There is no justifiable business reason to choose a stale score over a fresher version of that same score.

Dealers may rely on the old score and use the wrong rate or even assume erroneously that an application will be approved. The practice of having old scores avail-

able can lead to problems. For example, a dealer can purchase a credit bureau score based upon a 1995 development (a stale score). Then, the dealer can use a current pricing sheet from a lender to quote a favorable rate and sell the car. However, the lender then pulls a score on the applicant -- the same score product, from the same bureau, on the same applicant, but based upon the most recent 1997 development. The lender will receive a different score value, and potentially a different pricing tier or even a different accept/decline decision will be indicated! Since the dealer has already "spot-delivered" the vehicle in reliance on the 1995 score, there is a major issue between the dealer and the lender.

One client that I have worked with suspected that some dealers might be intentionally purchasing "stale" scores in the hope that their deals will score higher and result in more favorable decisions. It is important that dealers avoid these potential mismatches and the potential added risk that they can cause. Lenders need to clearly specify on their pricing sheets which version of the generic scores would qualify for their rate quotes, and the consequences to the dealer of using stale scores. Further, a lender should track how often these "mismatches" occur at each dealer, and take action against dealerships with a high error rate.

Credit bureaus should discontinue old generic scores. Dealers should not use old scores, lenders should not accept stale scores, and certainly credit bureaus should not offer duplicate scores. Lenders need to take the initiative to ask credit bureaus to retire the stale scores. There is no reason to maintain three different versions of the same score, as one bureau does today. The credit bureaus can be educated about the confusion and costs that result from having duplicate scores available.

Issue Two - Auto industry options available for some scores can also add complexity. It is also possible to purchase generic credit bureau risk scores that have an "industry option" feature. This feature adjusts the score based upon performance within a specific industry group (some common ones include auto lending and credit card). This provides some additional fine-tuning for risk management purposes, and adds predictive power for auto lenders. The data that I have seen supports the value of these industry-adjusted scores, and their use generally does not add any cost.

That being said, there is problem of a mismatch between dealers and lenders (similar to the use of stale scores) when one uses an industry-adjusted score and the

other does not. Again, I would recommend that lenders make use of the most powerful risk tool available. Lenders must then make sure that the dealers that they work with also use it and comply with their tiered-pricing policies. Failure of dealers to conform to the required standard should be dealt with similarly to any other dealer program error. If dealer education doesn't work, persistent errors should result in refusal to accept deals at any rate other than that indicated by the lender's required industry-adjusted bureau score.

Issue Three - New releases of score products will create new industry-adjusted scores that thereby entail the "stale score" problem. According to published reports, Fair, Isaac is releasing a new set of more powerful "next generation" risk scores over the coming months, which will "allow lenders to approve loans to more borrowers," according to Sally Taylor-Shoff¹. Presumably, there will also be an industry-adjusted option with these scores, as there have been on earlier versions. This could result in not only multiple versions of the generic scores being available, but also multiple versions of industry-adjusted scores as well, i.e., the "Issue One" problem discussed above. This can result in confusion brought on by the increased combination of stale scores, fresh scores, and various options, all available to the lenders and their dealers. The potential for dealer abuse, higher administrative costs, and more "rate breakage"² is very real.

Issue Four - Many lenders have found consistent geographic variations in loss rates from the same scores. Many vendors of generic bureau risk scores claim that the score contains all available predictive information so that adding geographic factors does not add predictive power to the scores. Thus, the vendors maintain that an applicant in Tulsa, Oklahoma with a score of 650 represents the same risk as one scoring 650 in Anchorage, Alaska. However, this assertion has not always been borne out by the facts. I have talked to many clients who have consistently seen significant differences in loan repayment performance within bureau score ranges by region, by state, and even within the same state.

If you are a lender doing business across a wide area, it is to your benefit to perform some additional

analysis of this issue. I would recommend producing some reports breaking out loan performance within score ranges across different regions. You might see, as a hypothetical example, booked accounts within the 650-659 score range performing with Good/Bad Odds (a ratio of good payers to bad payers within a population) of 10:1 in the Southeastern region, and perhaps with Odds of 14:1 in the Midwestern region. Results like this would be worthy of further investigation to determine the cause.

Assumptions about the equivalency of generic scores across other key applicant characteristics, like age, should also be tested. It also makes sense to test other commonly held beliefs about the use of risk scores. For example, is a 23 year old borrower, who has never borrowed more than \$500 on a department store credit card, and scores 700, really the same risk as a 35 year old borrower with 10 trade lines, and 2 paid off auto loans, who scores 700? I would suggest that if you performed some analysis comparing borrower performance by attribute (such as time in credit file, revolving utilization, etc.) within score ranges, you might gain some insights that could help you establish more meaningful credit policies.³

In summary, it is valuable to test common assumptions about the use of generic credit bureau scores, which are valuable but increasingly complex tools. We recommend that lenders examine the potential impact of any new scores, particularly on their cutoff strategies and acceptance rates, before adopting them. Any new predictive tool that adds improved decision-making power is worthy of consideration for implementation. However, some analysis is required before implementation in order to determine the overall effects. For example, just switching over to a new score, and using the same cutoff strategies, could result in surprises as score distributions shift, and acceptance rates change.

AFU Note: Portfolio Defense Consulting Group works with a variety of financial institutions to help them ensure that their scoring strategies and credit policies work in harmony with each other. The company stresses its independence from any credit bureau or scoring models in its work. The firm can be reached at www.portfoliodefense.com or (415) 492-8262.

¹ "New Credit Scoring System Should Help High Risks", *San Francisco Examiner*, October 3, 1999.

² "Rate breakage" refers to the dealer use of a rate below the required rate for the tier indicated by the bank scoring system.

³ We recognize that there is a trade-off between the refinement of the use of credit bureau scores and the complexity that can be tolerated by the indirect marketplace. However, some lenders are using the scores without sufficient knowledge of the impact on their loss ratios and without a full assessment of that trade-off.