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MARKETPLACE

# When an Ounce of Prevention Equals a Pound of Cure

*The golden rule of risk management for many installment lenders is to keep maturities short, loan amounts small and interest rates high. But bigger competitors with more sophisticated pricing methods are moving into that market, crimping margins for the traditional storefront lender.*

*Combating the competition means that small lenders need to employ the same kind of sophisticated technologies that the big companies use. The only problem is that the cost of those systems is typically beyond the reach of mom-and-pop lenders.*

*Peter DeForest, a principal with* **Portfolio Defense LLC** *in San Rafael, CA, worked with many specialty lenders during his days with Fair, Isaac & Co. These days he is attempting to make sophisticated risk management techniques affordable to smaller lenders.*

*"The point of my company is to try to make some of this technology available to folks in the mid-tier and in the niche markets on a more affordable basis so that they can still be competitive," DeForest said in a recent interview. "We think that there can be a better and less expensive way of providing similar technology at a reduced cost and better customer service to these markets."*

*DeForest recently spoke with James C. Allen, editor of Specialty Lender, about some of the risk management issues facing specialty lenders.*

***SL: Is it really necessary for a specialty finance company to devote resources to***

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# A Pound of Cure

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***risk management?***

***DeForest:*** You really want to think about risk management as one of your basic safety systems. You don't have to do everything at once. It's really something that should not be put off.

You have to ask yourself, "what is the risk of a loan that goes bad?" I've seen some folks who are making $15,000 and $20,000 loans to people with very low bureau scores, people that I would not want to touch. So how many of those people have to go to charge-off before you've paid for everything I'm talking about here? Twenty of them in a year at $15,000 a pop is $300,000. If you can save yourselves those 20 people in a year you've paid for it. So it can be foolish economy to not have these systems in place.

Also, what is the cost of having government regulators come in and tell you you're behaving in a discriminatory fashion or to engage you in a lawsuit?

***SL: What are the risks that lenders need to watch?***

***DeForest:*** There are other risks that can even be larger than the charge-off risk. One thing that happens, particularly in installment lending, is the issue of prepayment. For larger lenders in some types of portfolios, the prepayment risk actually can be greater than the charge-off risk.

It's all a factor if you're not offering the right deal to someone. They may take it just to get the car, but they're likely to come back a week later or month later and find a better deal.

***SL: Adverse selection is a risk that is seen mostly after an account is booked. Does it happen in the application process as well?***

***DeForest:*** One of the other problems in lending is once you approve someone it doesn't mean they're going to take the loan. In fact, one of the biggest problems is among the highest-quality applicants. They have other options. If you offer a price that is 200 basis points above what your competitor is offering, that person is going to take the other deal.

First of all you want to use the application processing system to make the decision quickly. Obviously it has to be a good response. It has to be competitive so the price has to be right, and it also has to be right for you in terms of your profitability as a lender. If you under-price your deals from a risk standpoint, in the long run you're going to lose money.

***SL: What is the appropriate role of risk managers?***

***DeForest:*** What the risk-management group would do is supervise the development of a custom model, manage the vendor relationships, supervise the installation and use of all these systems and implement policies. You don't throw your credit policies out the window when you use a score-based technology. You're using your credit policies in conjunction with the technology.

You can actually test your policies. One of the services my company offers is some ad hoc analysis and policy testing where we work with clients to see which policies are working and which policies are just needlessly turning down applicants that would otherwise perform well.

You need people who have skills in a lot of areas, and that's more difficult because people are expensive. For a mid-tier lender it can be difficult to have folks who can perform all those different functions.

***SL: How should a specialty lender go about implementing a risk-management program?***

***DeForest:*** When a little village in Africa wants to get a water supply they dig a well, and they put in some real simple stuff, and they get the basic water supply. They don't put in a 500-mile pipeline.

It's really very similar in terms of risk management. For the larger lenders, they have the resources, they have the large portfolios that can justify substantial expense in the area of risk management; in large, highly customized application processing systems; in a large number of custom models; in a variety of different scores and different strategies and tracking tools. In some cases the very largest lenders have their own statistical modeling teams.

There are risk management tools that are available, certain scores you can purchase from the bureaus and there are a lot of tools that you can get via the bankcard processors.

***SL: What can a small lender expect to pay for a risk-management system?***

***DeForest:*** If you're talking about any kind of adaptive control account management tools, you're talking about $350,000 to $450,000 or $500,000. If you're talking about being able to implement and test strategies on the front end, again you're talking about hundreds of thousands of dollars. And if you're talking about building a large number of custom models you're starting to talk about $300,000,

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Portfolio Defense LLC

$400,000, as well.

And that's not the cost of having full-time staff. That also doesn't include the systems implementation cost and the cost involved in tracking the performance of your models and changes in your applicant population.

***SL: What might a company that is a ".com" lender and is originating, say, $750 million to $1 billion a year in home equity loans expect to pay for third-party services like those you offer?***

**DeForest:** I have to make a lot of assumptions about what they might need. It's certainly going to be less than $200,000, but whether it's $100,000 or $150,000 is really going to be a function of how much data they have, how many custom models they need. That would be more or less the ballpark, excluding systems.

***SL: Would each of your customers have a customized risk-management program?***

***DeForest:*** Yes, definitely. It needs to be tailored to what their overall objectives are. It depends on where they're doing business. In some cases speed of decision might be important in a marketplace. In another case the actual price that you come back with and risk-based pricing might be the key factor.

***SL: What are some of the basic things a lender should want?***

***DeForest:*** You want to have some kind of a scoring process in place. There are some lenders who have small portfolios and as a result they can't necessarily build what's called a custom origination model. But even if you can't build a custom model there are certain generic models that are available to you until you actually have some data.

***SL: What are the advantages of buying a generic scorecard?***

***DeForest:*** It's a way to get started. As long as you're using it and tracking [the performance], it's not a dangerous thing to do. A dangerous thing to do in the area of risk management, in almost any area, is to be using a process and not tracking it. If there are changes in the quality of your applicants or changes in the quality of the people that you have on your books and you're not tracking that, you can really be blindsided. All of a sudden your delinquencies jump; your charge-offs jump, and then you're trying to find out what caused it.

***SL: What comes next?***

***DeForest:*** Once you have those models in place you need to determine where you want to set your cutoff. There is something we call the odds-to-score relationship. For a given score, there's a relative level of quality, which is measured by the odds at that score. So let's say at a score of 200 you have 20-to-1 odds, meaning that for every one bad you have 20 good. As the score increases those odds should increase.

***SL: Surely that person's score will not remain the same forever?***

***DeForest:*** That's where tracking comes into play because the applicant populations can change over time. What the applicants looked like a year ago or two years ago could be very different from what they look like today because that's driven by the economy. If there's a recession or an economic down cycle, someone who scored 200 a year ago, may now be 15-to-1 or 10-to-1. All of a sudden people start losing their jobs, or incomes aren't rising as rapidly.

***SL: What other benefits do scorecards provide?***

***DeForest:*** The regulators are really focusing on this, and folks at the OCC and a

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number of other federal regulators are becoming more and more sophisticated. They're looking for evidence of discrimination, and use of these scoring tools can really remove the risk of discriminatory practices.

Another reason might be just the competitive nature of installment lending. All of the larger lenders that I'm familiar with are using this technology. And if you're not, it's like being in World War II and you're riding up the hill on horseback while the other guys have machine guns.

***SL: These days underwriting systems and the systems used to manage risk once they are on the portfolio often do much the same thing. Can a lender buy one system and cover everything from applications to collections?***

***DeForest:*** What you're talking about is what's commonly referred to as a "decision engine" or "adaptive control." You're basically applying and using strategies on either the front-end decision — are you going to accept or decline the applicant and what terms are you going to offer them? Then there's the account management side of things, which is once you've put them on the books, how you are going to manage them from the standpoint of collections or trying to cross sell new products to them?

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The answer right now is no, there isn't one system that does this. There are individual systems and some players in the industry are moving towards having one system. But that's still not the industry standard.

The industry standard right now is you buy an application processing system, you buy a front-end strategy decision engine and you buy an account-management decision engine. They can all talk to each other.

***SL: Is there any evidence of the usefulness of all of this technology?***

***DeForest:*** What I've seen in terms of mergers and acquisitions is that the companies that are being acquired have tended to be very slow to adopt this management technology. They've tended to have riskier portfolios, and their performance has not been as good. The acquirers have tended to be larger and more successful because they've been early adopters of the technology. SL

*—JAMES C. ALLEN*