Custom Credit Scoring

A GDS Link Whitepaper

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This GDS Link white paper explains the value of custom credit scoring models versus the use of standard generic bureau scores, especially in today's economic climate.

THE BUSINESS ISSUE EXPLAINED

Using generic credit bureau scores is like buying a pair of size 10 shoes because that's what the national average shoe size is for an American male. Even though they are too small or too big, size 10's are the norm and are what most have learned to "fit" into. Generic bureau scores were modeled off of samples pulled from the entire US population, without any degree of adjustments for regional or portfolio differences.

For example, sub-prime consumers in Florida are grouped with high income people in California, who are grouped with limited credit history people in South Dakota without any consideration of cost of living, property values, local economic conditions, manufacturing regions, or any number of other demographic information. They also do not consider the specific products and marketing strategy of the lender using the score. Data is pooled and a one shoe fits all strategy applied. We are all computed the same way to get our credit bureau score–AND everyone seems to accept this as OK. Some of our complacency in the US stems from our abundance of credit bureau data. This data does form a good basis for a strong scorecard, but it does not mean the same generic scorecard will be effective for all lenders, all products and all consumers. In other countries credit bureau data is more limited, so lenders benefit from greater use of custom models. Data richness does not equate to generic scorecard adequacy.

It is often believed that custom models are unnecessary and costly. However, custom model developments regularly show substantial improvements in performance over the generic alternatives. If the addition of a custom model will even marginally improve your ability to price your offer and reduce charge-offs, then it will likely pay for itself in short order. Think of the consequences of even a 12% reduction in bad debt for your portfolio, or a 10% increase in volume. The typical custom scoring solution will continue to yield benefits far greater than this, year after year.

GDS Link surveyed over 100 banks to produce the following statistics:

- 71% of Banks surveyed still currently use Generic Bureau Scores
- Only 22% of Banks surveyed were satisfied with the performance of Generic Bureau Scores
- The biggest complaint found with the current process was the ability to accurately track the performance of the scores used.

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Secondary markets have been unable to comprehend anything other than generic scores, providing no incentive for financial institutions to do a better job at credit scoring their portfolio, when their sole focus is to sell their paper. This will change as awareness grows of the limitations of bureau scores, and alternatives become more feasible. While many in the industry like to think that a bureau score of 640 means the same thing all the time, it is simply not true. Regulators, lenders and secondary market players are slowly recognizing this fact, opening the way for alternatives. In fact, one of the market's most prolific suppliers of generic credit scores actually acknowledged that their mortgage based scores were not as up-to-date as they could have been. Does this contribute to the over-extension of credit and subsequent losses that ensue? Absolutely.

The good news is that most financial institutions understand the philosophical importance of creating custom scores based on their target market and business objectives more than at any other time before. However, many are slow to undertake the research and effort required to create the analytics, implement the models and then validate them periodically to ensure the efficacy and stability of the models. Most financial institutions realize that one size does not fit all, especially within the local demographic region they are operating in, as every region, market and target population is different.

BUSINESS ISSUE NUMBER 2 – WHY ADOPTION OF CUSTOM MODELS HAS BEEN SLOW TO DEVELOP

Custom scoring models can seem to be expensive before understanding the long-term payoff. You have to either hire statisticians or outsource to a third party scoring and analytics company. Access to historical data to build a new custom model based on your business objectives and your target market, combined with the essential ongoing reporting function to track score success seems to be beyond some organization's means. Once the model is built, you need to implement it into your online production environment(s), and then through validation and monitoring, update the model on a regular basis. As your target population and market conditions shift, your business needs also change and so must your risk strategy methodology.

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However, what many tend to overlook, is that for the correct use of generic bureau scores, a validation on your own portfolio is required before you can set appropriate business strategies. On-going validations are also needed to ensure your risk strategy is staying on track. Data is needed for this analysis, which begs the question, how much more effort and cost is involved in developing and implementing a far more effective custom scoring solution?

SOME OF THE ANSWERS

Technology has evolved dramatically in the last 20 years. Do you feel tied to your legacy applications and their inherent limitations? Well don't. Financial institutions looking for innovation and dynamic agility for adapting to change can now add or extend current capabilities easily and efficiently.

Service Oriented Architecture (SOA) supports the modern paradigm for on-demand systems, and today's competitive marketplace demands robust, yet affordable technology that can enable quick responses to changing circumstances. Your organization needs technology that can empower business users to create on-demand "Services" that can be deployed across the enterprise, copied, modified and reused at will. Moreover, you benefit from retaining and reusing the data that you have already captured and already own. Most of the cost associated with a custom scoring system comes from data collection and processing. SOA slashes these costs, and removes the need for the time consuming and expensive purchase of archive data from the credit bureaus. With data needs taken care of, there is no excuse for not implementing custom scoring.

Software today makes it easy to track the performance of your analytics and scorecard models. You can update or react to economic change at the push of a button. There are no technical barriers in today's world that cannot be easily overcome. Research the possibilities or contact GDS to understand how they can help you unleash the power of advanced analytics.

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