Vision 2010 Conference
New strategies for a new reality

Making your credit scores work for you

Andrew Bieno, Experian Decision Analytics
Mike Horrocks, Experian Decision Analytics
Agenda

- How are scores working for you today?
- Key factors for validating and monitoring your decisions
- A deeper understanding of your credit scores
- Gaining operational efficiencies from scoring
- The future of your scoring solution
- Questions and answers
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Hindsight

“There was a systemic lack of skepticism ... one of the industry's biggest mistakes was rationalizing poor decisions made earlier in the decade.”

*Lloyd Blankfein, Goldman CEO*

“No one understood the risks. I compare it to bad sangria. A lot of cheap ingredients packaged together might taste good for a while, but eventually it leaves you with a headache.”

*Michael Mayo, Calyon Securities Inc.*
How do we get out of this situation?
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Key factors for successful validating and monitoring

Critical steps for a successful validating and monitoring process include:

- Data aggregation
- Analytical expertise
- Rigorous analytics
- Flexibility throughout the process
- Reporting for all levels
- Transparency
Aggregation

- Incorporate the relevant enterprise data
- Complete the risk profile with:
  - Basis for the initial decision
  - Status of the current condition
  - Potential based on scenarios for the future
Expertise

- Recognize the needs for expertise during your validation and monitoring exercises
- Third-party validations will provide:
  - Regulatory ready reports
  - Unbiased recommendations
  - Overall industry insight
  - Best practices
  - Diagnosis and prescription outside of internal factors
Analytics

- Analytics must be able to draw across all aspects of the enterprise
- Driving down to the unique attributes associated with each credit decision is critical
- Analytics must be defendable and accessible for future reviews both internally and externally
Flexibility

The process around validating your scores must be able to adapt to the analysis needs of multiple factors, such as:

- Time
- Risk
- Asset allocation
- Performance attribution
- Regulatory changes
- IT and infrastructure changes
Reporting

Reporting must address:

- Macro-economic risk analysis
- Needs of internal risk management
- Regulatory and compliance needs
- Strategic planning and business development needs
- Coaching and mentoring opportunities within the credit and business development business units
Transparency

Validations and monitoring must:

- Shed light on internal issues
- Provide accountability to shareholders
- Identify opportunities for management and mentoring
- Provide access for regulatory bodies to ensure compliance
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Scorecard validations

Purpose

A scorecard validation ensures the model is successfully ranking risk (identifying a creditworthy individual vs. non-creditworthy individual) at the point of application.
Impact of invalid scorecard

- Increased portfolio risk
- Decreased efficiency and consistency
- Escalating costs
- Minimized management controls
- Lower profitability
Model effectiveness

Although the KS might be acceptable, there could be a better scorecard option available.
Population distribution

- Distribution will change over time

- Causes of change
  - New products
  - Economy
  - Competition
  - Pricing

- Impact of changing distribution
  - Additional risk
  - Lower profitability
  - Lower approval rates

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<th>Score</th>
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<td>&gt; Low</td>
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Cutoff scores

- Cutoff scores should be used to increase efficiency and consistency
- A primary cutoff score should be established to separate approve from decline
- Secondary cutoffs may be established for automation purposes
- Utilize the following when setting cutoffs
  - Distribution of applicants
  - Targeted approval rate
  - Targeted bad, loss or odds
  - Natural cutoff as seen on override report
### Decision management

- **Accept vs. decline = 73.48**
  - Measures consistency in decisions regardless of cutoff score
- **Overrides**
  - Measures adherence to the cutoff score
  - High side override – 102 / 990 = 10.30%
  - Low side override – 36 / 385 = 9.35%
- **Lender decisions do impact how the score will perform on your portfolio**

<table>
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<th>Score</th>
<th>Approve</th>
<th>Cum. approve</th>
<th>Decline</th>
<th>Cum. decline</th>
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Case study
Validation results

- KS results were 9.36 on one generic score and 8.18 on another.
- Although there were no previous validations from this client to compare, validations of similar institutions in the area reported much higher results.
Digging in

- Accept vs. decline = 37.04
- Overrides
  - High side override – 2906 / 7378 = 39.39
  - Low side override – 262 / 2416 = 10.84

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<tr>
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<th>Approve</th>
<th>Cum. Approve</th>
<th>Decline</th>
<th>Cum. Decline</th>
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<td>93.66</td>
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Digging a little further

- Booking rates were relatively low in higher score ranges
- Bad rates were high in higher score ranges
- Client was being adversely selected due to pricing

<table>
<thead>
<tr>
<th>Score</th>
<th>Booking rate</th>
<th>Bad rate</th>
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<td>&gt;700</td>
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<tr>
<td>Total</td>
<td>66.60</td>
<td>9.71</td>
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Caution needs to be taken not to look at results at too high a summary level; details can be lost!
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Gaining operational efficiencies

Operational efficiencies and revenue gains obtained via:

- Automation in decisioning
- Grey area strategies
- Application to documentation
  - Using scores and systems to limit manual intervention
Automation gains

In the race to address your customers needs remember:

- System capabilities
  - Flexibility
  - Responsiveness
- Minimizing policy overlays
- Automating declines
  - Frees up time to develop business and a quality portfolio
Focusing the decision

Develop strategies (and stick to them) that complement your risk profile

- Different strategies for different products
- Define rules for 90% of the scenarios and when you come to 10% of those “forks in the road”, leverage past experience
- Establish grey area policies that support anomalies
- Revisit decision processes often based on your on-going monitoring activities
Workflow optimization

Optimize the lending process

- Review workflows and activities in each step
- Using scores to limit manual interventions
- Maximize the lifecycle associated with each piece of data gained and entered into the system
- Start with the goal in mind of making the workflow have minimal interruptions from application to booking
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Progression of scoring

Generic scores
- Available at the bureau
- Built on all industries and trade types
- Cannot be customized

Industry specific
- Not always available at the bureau
- Built on a specific industry or trade type
- Some can be customized and use application information

Custom models
- Can be coded at the bureau or in house
- Built on the data of a specific client
- Tailored to the specific needs of the client
- Requires significant data
Dual tool scoring concept

- Combining a risk score with a bankruptcy score provides a powerful decision tool
- Bankruptcies represent a large portion of the losses a financial institution experiences
- Collection activities are restricted once an account files for bankruptcy
- Many applicants perform as a good account up to the point of filing bankruptcy
Call to action

- Understand how your score is performing on your population
- Utilize operational efficiencies for automation and documentation
- Continue progression of your scoring and decisioning system
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For additional information, please contact:
Andrew.Bieno@experian.com
Mike.Horrocks@experian.com