# CREDIT SCORE OPTIONS

**Today's lenders have lots of choices. What's the right use of scoring technology for your CU?**

BY KEN WILLIAMS

Managing loan risk was historically between the lender and the borrower. With the advent of empirical technological solutions, a third party, the credit score, was added into the equation.

Scoring is supposed to make life easier for the lender, but is it resulting in more confusion? With the Vantage score (*www.vantagescore.com*) adding yet another option, it is worthwhile to see where we are today. This article is a snapshot of today's scoring environment and will visit four key areas important to retail lenders: 1) What are today's marketplace choices for score sets? 2) Why are lenders increasingly turning their backs on the marketplace choices? 3) Four key fundamentals to a better understanding of scoring. 4) The six steps necessary to make credit scoring a full partner in the lending process.

**FIGURE 1: LENDERS' CREDIT SCORE OPTIONS**

| Company | Score Set Name | Score Set Designer | Subset Model |
|---|---|---|---|
| Equifax | Equifax Risk Score | Equifax | N/A |
| | Beacon 5.0 | Fair Isaac | 30 |
| | Pinnacle 1.0 (Next Gen) | Fair Isaac | 29 |
| | Pinnacle 2.0 (Next Gen V 2) | Fair Isaac | 30 |
| TransUnion | Trans Risk | Trans Union | N/A |
| | Empirica | Fair Isaac | 24 |
| | Precision (Next Gen) | Fair Isaac | 24 |
| | Precision 2003 (Next Gen V 2) | Fair Isaac | 26 |
| | Next Gen FICO Scores | Fair Isaac | 26 |
| | FICO Risk Score Classic | Fair Isaac | 26 |
| Experian | Scorex Plus | Experian | N/A |
| | Fair Isaac Risk Model (FICO) | Fair Isaac | 30 |
| | Advanced Risk Score (Next Gen) | Fair Isaac | 30 |
| | Fair Isaac Risk Model V3 (FICO V3) | Fair Isaac | 30 |
| | Fair Isaac Advanced Risk Score (Next Gen V2) | Fair Isaac | 29 |
| Fair Isaac | Expansion Set | Fair Isaac | 4 |

## MARKET REALITIES

Today's lenders have a confusing array of scoring model choices. They can select from 16 score models that have 340 subsets or sub-populations. Subset models include such classifications as sub-prime, auto, bankcard, retail revolving and bank installment. These are used for product- or industry-specific lending.

The models of three credit reporting companies and Fair Isaac are shown in Figure 1. Fair Isaac is included because its expansion model is used to grant credit for potential borrowers with little or no credit. For the most part, the designer of each score set is Fair Isaac, although each reporting company does have its own model.

The recently introduced Vantage score model, purported to be more consistent and predictable, is too new to be included in this comparison.

## UPGRADED MODEL?

Faced with this confusing array of options, it's no wonder lenders turn their backs and are reluctant to budge from their historic model of choice. The actual offering of scoring models has been pared down by lender demand to those shown in Figure 2.

**FIGURE 2: LENDERS' CREDIT SCORE CHOICES**

| Company | Classic | Next Gen V.2 |
|---|---|---|
| Equifax | Beacon | Pinnacle 2.0 |
| TransUnion | Empirica | Precision 2003 |
| Experian | FICO | Advanced Risk Score 2.0 |

For the most part, lenders have stayed with the classic line of credit score models and few have migrated to the next generation versions. In a number of cases, lenders were even reluctant to upgrade to the newer versions of the classic models and only did so when the credit reporting companies stopped providing support for the older version.

In my observations during 30 years in financial services, the reality of score set usage is also driven by the asset size of the institution, as shown in Figure 3. This is a dilemma for both the score providers and the lenders they serve. The credit reporting companies would like to see greater use of the newer models that were a significant investment for

**FIGURE 3: SCORE SET TYPE TYPICAL USAGE**

| Lender Size | Score Set | Subset | Importance of Score in Loan Decision |
|---|---|---|---|
| Small | Classic | No | 25% |
| Medium | Classic | No | 50% |
| Large | Classic/ Next Gen | Limited | 80% |
| Very Large | Custom/ Classic/ Next Gen | Yes | 99% |

them. Lenders are reluctant to implement changes in their process since any change affects the dynamics of risk management. The entire lending process is a tender balance of saying yes to the greatest number of borrowers while keeping losses at a minimum. This inherently places both groups—who are business partners—at odds when it comes to score set upgrades.

## UNDERSTANDING SCORING

Lenders need to take to heart four basic facts concerning empirical credit scoring technology.

1. ***Credit scoring technology evolves over time.*** Some of the classic credit scoring models are based on data from 1995 to 1997. Do you use a 10-year-old computer?

2. ***Newer score sets and their subsets provide higher levels of precision*** when properly applied to the underwriting process.

3. ***The level of risk for a given point score will be different when the score comes from a different one of the three credit reporting companies.*** Figure 4 shows the point score-to-loss ratio for the same model offered by the three credit reporting companies. In the critical mid- to lower-600s, the loss difference can be plus or minus 100 basis points. This does not mean one model is less effective for use than another. It only means the lender must revisit cut-off score assessment if the credit score company being used is changed. This difference stems from the fact that each score is based on slightly different definitions and inputs to the mathematical model.

4. ***The level of risk for a given point score will also be different within a single credit reporting company using the same model, but different subsets.*** Figure 5 shows this relationship. Again, this is not a flaw in model design but recognizes the differing risk parameters within the subsets. It actually shows the subsets can be more precise.

## MOVING FORWARD

Lenders have options for navigating the enhanced scoring environment.

1. ***It is worth the effort to upgrade to the newer models.*** Lenders still have to validate their results with the projections from the score model. This requires, in some cases, additional reporting and analysis, for example, static pool and vintage analysis, the comparison of actual to projected results in a group of loans. (See point 6, below.)

2. ***Newer models are more precise.*** If you are using one of the classic models, it's time to upgrade.

3. ***Subset models are more precise.*** See if your volumes justify the effort to adopt multiple subset models. Many of the application processing systems available in the market can accommodate multiple models for the front end.

4. ***Consider elevating the weight of a credit score in the overall decision process.*** This will pay dividends in reduced costs and, with higher precision, there is no increase in risk. Many CUs may use the credit score as well as a number of other underwriting factors, such as a debt ratio, to make the yes/no credit decision. With higher precision, a lender can consider reducing the number of other factors and placing the most reliance on the credit score. This accelerates and simplifies the credit-granting process. Today more confidence can be placed in scores because they are becoming more reliable.

5. ***Understand there can be point differences between models and revisit risk level cut-offs and rate assessment tiers.***

6. ***Internally track your own results by point score.*** The best validation is an internal one.

The fact that most lenders are not taking full advantage of what the technological advances in credit scoring can do for them is good news. It means migrating from last century's technology to the best now available can provide a significant opportunity to enhance risk management, reduce expenses and increase the bottom line.

**FIGURE 4: SAME MODEL, DIFFERENT COMPANY**

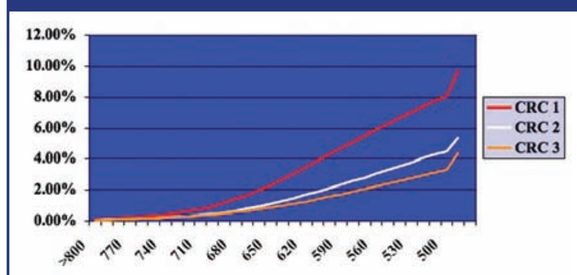
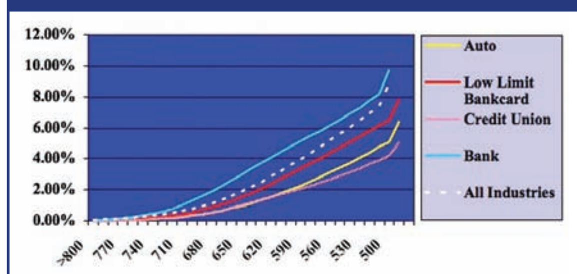



**FIGURE 5: SAME MODEL AND COMPANY, DIFFERENT SETS**




## RESOURCES

Also read "Look Back to Look Ahead" about credit-checking at *cumanagement.org*. Choose "March 2002" from the "Past Issues" pull-down menu.

Read more about a new idea for applying credit scores in "Small Innovation Sets CU Apart From Banks" at *cumanagement.org*. Choose "Marketing" and then "Filene i3 Project Articles."

Read "Upping the Score," about mining credit score data for marketing, at *cumanagement.org*. Choose "Operations" and then "Lending."

Learn more about the School of Business Lending at *cues.org/sobl/*.

**Ken Williams** *is president of KW Financial Solutions* (www.kwfinancialsolutions.com)*. Reach him at* ken@kwfinancialsolutions.com.