eurofinas

SPECIALISED CONSUMER CREDIT PROVIDERS IN EUROPE

Mr Rob Steele
Secretary General
International Organization for Standardization
Geneva

By email: steele@iso.org

CC: ISO President Dr Alan Morrison

Brussels, 20 April 2009

Re: Eurofinas' comments on the ISO proposal: Specification of Requirements on Consumer Credit Scoring

Dear Mr Steele,

Please find enclosed hereto Eurofinas' comments on the above-mentioned proposal which may be of interest to you and your colleagues at the ISO central secretariat. You will recall that the proposal was circulated to ISO by its Austrian Member ON on 28 January of this year.

In our comments we stress the bespoke nature of consumer credit scorecards. Such scorecards are the trade secrets of the lender to which they belong. Indeed, they are developed according to a lender's own business model (and risk sensitivity).

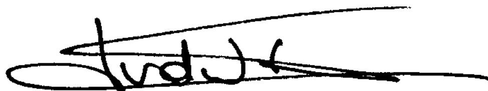
Hence we voice our opposition to the development of a standard which '*will provide requirements for procedures of lenders to assess creditworthiness in the retail business quantitatively with credit scorecards in the focus of the process*'.

We also believe that the construction of bespoke scorecards tailored to (inter alia) the product involved, the distribution channel used and the amount of credit bureau data available contributes to responsible lending.

Whilst the industry fully agrees that promoting good practice in itself is laudable, codifying it, in this instance through a standard, is not the most appropriate approach. Instead, having robust standards of transparency, documentation and competence would be more beneficial in terms of consumer protection.

I stay at your disposal to answer any question you may have on our comments below; alternatively feel free to contact my colleague Ravi Bhatiani (r.bhatiani@eurofinas.org - tel: 0032 2 778 0562).

Yours sincerely,



Tanguy van de Werve
Director General

About Eurofinas

Eurofinas, the European Federation of Finance House Associations, is the main voice of the specialised consumer credit industry at European level. It currently represents 16 Member Associations, in turn bringing together more than 1,000 finance houses, captive companies, specialised and universal banks. Together, these consumer credit providers financed over 400 billion euros worth of new loans during 2007, with outstandings reaching 713 billion euros at the end of the year. Companies represented through Eurofinas employ some 90 000 individuals.

Consumer credit providers may be of several natures and our members' members can be grouped into the categories below. Around 90% of the companies represented through Eurofinas are specialised lenders, falling into the first three categories:

- Finance houses: specialised consumer credit providers without a banking licence;
- Captive companies: parent companies of these companies are manufacturers (e.g. car manufacturers). Captives may or may not have a banking licence;
- Specialised banks : institutions with a banking licence but an activity focused on consumer credit or/and mortgage lending; and
- Universal banks: banks providing all kinds of products retail, corporate, etc., including consumer credit.

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Eurofinas, the voice of specialised consumer credit providers at European level, hereby would like to comment on the recent ISO proposal titled "Specification of requirements on consumer credit scoring".

1. Consumer credit scoring is a trade secret

Details of existing scoring methods and how they work are trade secrets which belong to (and confer economic benefits upon) the lenders using them.

If any proposed standard required *detailed* disclosures of consumer credit scoring methods, other lenders would gain considerable advantages through knowing the said scoring methods of their competitors.

Therefore, there should be no duty (nor any indirect requirement), to disclose detailed[1] consumer credit scoring methods within any proposed standard.

If the details of such scoring methods were to be disclosed (as a result of standardisation or through other (legal) requirements), the security and accuracy of the credit referencing system would be greatly reduced. This could be the case where either a loan applicant or a finance company employee - such as the loan officer in charge of granting the credit uses the disclosed information to make fraudulent applications. By knowing which information items are taken into account in the score or which criteria have a larger weight within the overall score, the applicant or officer may falsify the data when applying for the loan.

That being said, finance companies *can disclose* to consumers the *general principles* of credit scoring. Indeed, helping potential borrowers understand the underlying mechanisms of credit scoring is one way in which a lender can contribute to a borrower's financial education in the context of responsible lending.

2. Deciding upon acceptable levels of risk is a business decision

We note that risk assessment is a core competency for a lender. As such, consumer credit scoring models are developed from a lender's own data and experience, appropriate for its business model and risk appetite.

Importantly, in order to satisfy the business objective which it is addressing, a lender should be free to use what data, outcome periods and outcome definitions it needs in such scoring models.

Indeed, consumer credit scoring is merely a tool to deliver the risk appetite of a lender in a consistent and objective way.

[1] Detailed information would include the information criteria used in a creditworthiness assessment and each criterion's individual weight in a credit score. Such information must be kept confidential.

3. Standardised scorecards are usually inappropriate

A scorecard is a statistical model that consists of a range of characteristics, the combination of which provides the greatest level of differentiation on the portfolio for which it was developed.

The whole purpose of a consumer credit scorecard is to identify what characteristics predict best for a given portfolio, whereas a *standardised* scorecard merely provides something that can be used everywhere but is never optimal wherever it is used.

This is reflected in the construction of such scorecards, which are adapted to both the profile of the applicant borrower and the performance of the lenders loan portfolio.

In particular, scorecard content may be determined by:

- the ***type of financial product*** (see the example provided in the box below);
- the ***distribution channel***;
- the ***lending segment***;
- the ***availability of credit bureau data***;
- ***the data that is actually captured*** from the applicant borrower; and
- the business model of the ***participating lender***.

<u>Type of financial product</u>

A mortgage scorecard is very different to an unsecured loan or credit card scorecard, which is very different to a motor finance scorecard. A mortgage scorecard will certainly contain characteristics that are very predictive but which are not available to loan and credit card lenders e.g. Loan to Value, Income Multiple, Property Type.

It is a similar story for motor finance scorecards that will almost certainly contain characteristics such as Age of Vehicle, Cash Price to Guide Price, Percent Deposit, all of which are not available in unsecured lending.

A motor finance company might even have different scorecards for new and used vehicle finance because the risk profile of the applicant borrower and the performance of accounts vary between product categories thus requiring specific scorecard models.

There is a high risk that a scorecard designed for each particular product or segment will only be effective for that specific product or segment.

Accordingly, a standard scorecard would not be conducive to responsible lending if it were to be applied uniformly, without regard to the appropriate requirements of:

(i) the lender (whose business model revolves around (inter alia) offering a consumer credit whilst minimising the risk of loss); and

(ii) the consumer (who requires access to finance at an affordable price).

Scorecards in different countries

With regard to scorecards in different countries, there are further differences to consider:

(i) Some countries do not have credit bureaux. In countries where there are credit bureaux, many only contain negative data whereas others contain both positive and negative data.

(ii) In Germany, the population primarily rent their homes whilst in the UK there is a much greater level of home ownership, therefore the 'Residential Status' characteristic will work differently in those countries.

There are more examples but it is clear that the concept of a standard scorecard is unlikely to be effective, in part, due to basic social and cultural differences between countries.

4. Bespoke scorecards are more effective

Bespoke scorecards have proved more effective than standardised scorecards.

In the past, when introducing credit scoring as a discipline into the credit decision process, companies have built generic scorecards to be used in locations where little bespoke data existed.

In time, the use of generic scorecards captured a great deal of customer data and the said companies were in a position to build scorecards that were bespoke to the individual country and to the population of that country.

In most cases when such companies calculated the power of the bespoke scorecard as compared with the original generic scorecard the difference was approximately double the power - the bespoke scorecard in every location was twice as good in the decision process as that seen originally in the generic scorecards.

5. Promoting good practice

Promoting good practice in itself is laudable. However, codifying it through a standard is not the most appropriate approach. Instead, having robust standards of transparency, documentation and competence (i.e. having a clear governance framework) would be more beneficial in terms of consumer protection.

Annexe 1

What is scoring and how is it used in making lending decisions

When deciding on whether or not to grant a loan or credit facility to a consumer, a finance company has to assess the creditworthiness of its potential borrower, i.e. it must examine the individual's ability to meet his or her financial commitments to repay the loan.

Credit scoring is a computer-aided system used by most major finance companies and banks throughout the developed economies when considering applications for borrowing. Its use has been judged by regulators in many countries as being beneficial to the consumer, the lender and to the economy. The World Bank in particular supports its use.

To evaluate creditworthiness as objectively and accurately as possible, credit scoring systems carefully and precisely gather and use information about the customer from a variety of sources. The component parts of each system vary for each lender based on its own earlier experience gleaned from customers who pay well or badly. The end result is a scorecard containing a series of factors with associated numeric values but its development and validation uses established statistical principles In operation, the system gives points for each piece of relevant information and adds these up to produce a score. If the customer's score reaches a certain cut off level, the finance company will generally accept the application. If the score does not reach this level, the application may not be accepted without good reason.

Additional rules, reflecting the company's commercial experience and needs, may also be used when deciding whether to lend together with any relevant or up to date information. The score is a very important factor when determining whether or not to grant a loan, but it may not be the only one. Consequently the final decision is taken by considering all the information available.

Every credit or loan application involves a certain level of risk to the finance company, no matter what the quality of the potential borrower is. Credit scoring allows the company to work out a statistically reliable estimate of the risk level for each applicant. If the level of risk is deemed to be too high, the finance provider will not accept such an application. This does not mean that any applicant turned down is a bad payer. It simply means that, based on the available information and the experience with similar applications the finance company has, it is not prepared to take the risk of providing the credit applied for.

It should be noted that lenders are not obliged to accept any application and that each lender applies its own policies and has different scoring systems. Therefore, applications may be assessed differently by different lenders with the result that one company may accept an application while another company may not. Obviously, it is not in the best interests of lenders to turn down good payers or accept those that do not pay. For this reason, those using scoring systems keep them under constant review and check that the cut -off score is where it should be.

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