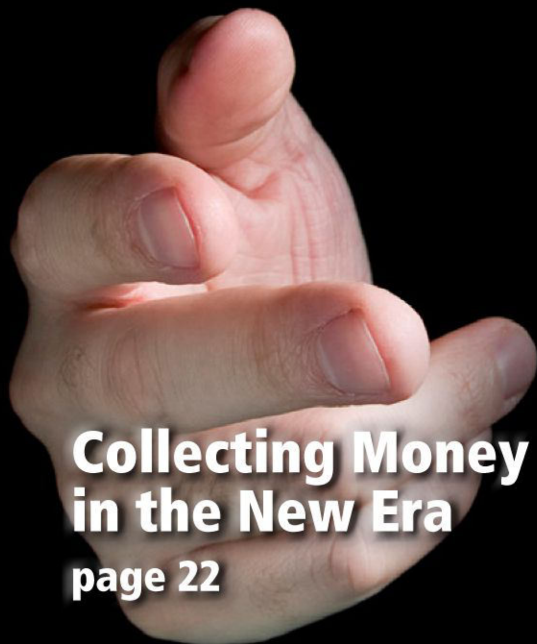
Vol. 5 No. 1 • January/February 2016

Non-Prime Times

Official Publication of the National Automotive Finance Association

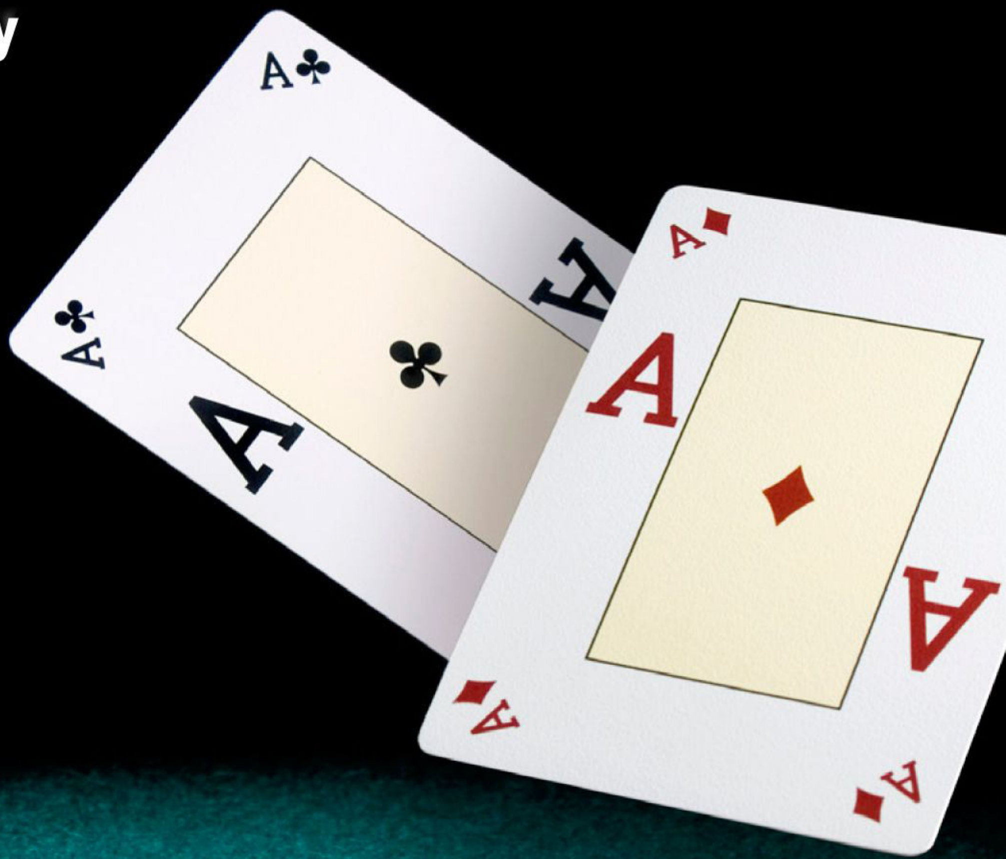
Counting Cards in Auto Finance



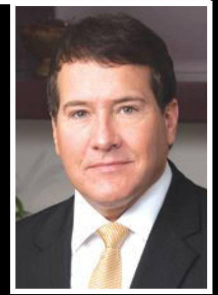
Collecting Money in the New Era
page 22

Know your Credit Reporting
page 20

10 Technology Questions to Know
page 28



Daniel Parry



Counting Cards in Auto Finance

The release of the latest James Bond film, and the rumor that it might be Daniel Craig's last, has rekindled my interest in the franchise. Instead of watching my beloved Cowboys implode on Thanksgiving, I chose 007 as a distraction and popped my copy of *Casino Royale* into the DVD player. One of the scenes that particularly caught my attention was the climactic high stakes poker game between the villain Le Chiffre and Bond.

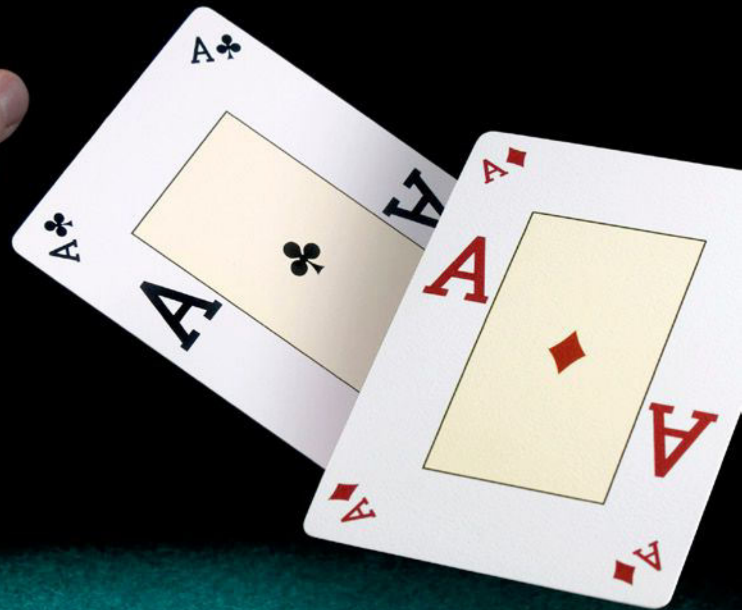
Early on in the game, Bond loses all his money when he misreads Le Chiffre's bluff. He is furious; because he is absolutely sure he can beat him. Fortunately, CIA operative Felix Leiter comes to the rescue and bankrolls Bond so he can stay in the game.

In the final round of the game Le Chiffre goes all in with four of a kind, but Bond beats him with a straight flush. While our hero comes out looking quite brilliant, the odds of that hand are 1 in 72,192. It is easy to forget that, only a few hands before, this same genius lost everything because he was cocksure he could spot a winner.

A call to automate

The recent Auto Finance Summit in Las Vegas featured a keynote speaker who by his own admission was new to the industry. The potential appeal of this is that one might hear a point of view that is not mired in a bias for business as usual. The speech centered on the familiar innovator's message of "if you don't change, you will get left behind."

At one point, the speaker made a case for automated credit decisioning. This was punctuated with the assertion that automated, model-driven decisions beat judgmental ones every time. While the statement was meant to be provocative, only about half of the people in the room took it that way.



For many in attendance, auto-decisioning has been standard for more than 15 years and they accept the speakers point as obvious. The other contingent grimaced at the thought, knowing that if they bought loans purely by the credit score their portfolio would blow up. The question is: who is right?

Stages of automation

There is a belief by many who embrace credit automation that the rest of the world is in the Stone Age. What these people forget is that every company adopting an automated approach got there through a protracted learning process. If automation were imposed before those companies were ready, it could have been disastrous.

In 1998, Capital One acquired Summit Acceptance Corp and over the next four years began to apply learnings from the credit card side of the business to auto finance until they gained a large degree of automation. Drive Financial Services was founded in 1992 by former car dealers who bought deep discount, bottom tier auto paper. In 2006, the company was acquired by Santander and over time built out a highly sophisticated analytic group. Both companies are examples of very successful automated platforms, but they didn't get there overnight. The progression toward automated decisioning tends to follow a well-defined path, characterized by four distinct stages.

Stage one – Expert judgment

This first development stage is usually built off the judgment of one key individual, or subject matter expert. The expert underwriter typically has a substantial understanding of what has worked and not worked in their past and very often a very well-developed philosophy toward credit. They believe in their ability to instantly tell the difference between a "good FICO" and a "bad FICO" with a cursory glance at the credit report, and cling to statements such as "if they have good car credit, they will always have good car credit."

Far from being unsophisticated, they are intuitively attuned to factors that contribute to poor performance based on experience. These factors include the customer's debt load, down payment, recent credit activity and performance on other car loans. Dealer and customer fraud is always at the forefront of their mind, as well as how the customer might perform given the vehicle being financed.

There is a belief by many who embrace credit automation that the rest of the world is in the Stone Age. What these people forget is that every company adopting an automated approach got there through a protracted learning process.

Businesses run by judgmental experts can do very well if they are consistent and price the business correctly. The challenge comes when these lenders need to expand operations, and so must find a way to get a larger group of less seasoned underwriters to behave as they do. Unfortunately, it is nearly impossible to impart the gut instinct of one individual on a larger group of people and get reliable results. For the company to move forward, the expert must sacrifice some control for standardization.

Stage two – Structured tiers

Companies that graduate out of stage one have recognized the need to formalize underwriting standards in order to be able to replicate consistent results as they expand. While these lenders don't trust a generic credit score for underwriting, they do recognize the fact that most competitors price off of it. For this reason, they will develop programs built off of score ranges, heavily supplemented with rules designed to ensure good credit performance.

The rules tend to be a complex restatement of the factors that were considered most important in the expert's judgment, with a certain amount of latitude baked in for the buyer to make deals. More often than not, the rules tend to get very complex in an attempt to account for every scenario. The complexity itself can lull a lender into a false sense of security about how effective the tiers are at mitigating risk, and can drive a level of exceptions that degrades the program back to a judgmental one.

The guidelines that make up each tier fall in three categories: rules that are correlated with credit loss, rules that are irrelevant to credit loss, and rules that are redundant (and less correlated) with other factors that are already being measured. Without a solid handle around the company's own data, and analytics to evaluate performance, managers are left to guess as to what is most important. Successful stage two companies build infrastructure around their own data, and start building out teams that can analyze that data.

Stage three – Score guided

As lenders continue to grow, increased scrutiny is placed on the company's credit operations. Capital providers want to know they are insulated from loose lending and push the company toward using objective metrics of quality, such as a credit score; however, stage three lenders still tend to be highly skeptical of the score as a meaningful underwriting tool. At this point, companies begin to leverage their own data warehouse and employ the skills of competent data analysts.

With the advent of newfound business intelligence, these lenders quickly learn to vet each credit assumption and modify their programs accordingly. They formulate credit tiers and decision parameters that are guided by a credit score, and are supplemented with

continued on P-15

The Credit Process, *Parry, continued from P-13*

a well thought-out credit policy. They also provide more latitude to consumers based on score. For example, the higher score, the more options they give consumers with regard to LTV, down payment, and vehicle choice.

Lenders that execute well at stage three are open to challenging long-standing assumptions regarding credit. They test data and find ways to refine their programs, while still using experienced underwriters as a safety net to protect credit. Most companies at this stage are comfortable auto-declining, but not auto-approving deals. What lenders must guard against is an avalanche of over-rides (fishing for loans below the cutoff, while over-riding a large portion of applications that score). If this happens, the company essentially reverts to a stage two company with stage three infrastructure costs.

Stage four – Automated decisioning

Knowledge truly is power. When lenders reach stage four, they have tested most pre-conceived notions about what matters in credit decisioning. They have also learned the most important skill in evaluating credit – counting the cards.

Consider the game blackjack. There are only three outcomes for any hand: win, lose, or push (tie with the dealer). The odds of winning on any hand relate to how the game is played over time, not on one hand. It is possible to lose 5 hands in a row that you had good odds on, but you play at your own peril if you disregard these odds for gut instinct.

In the same way, you can have a 600 credit score on a particular application. There are ultimately only two outcomes for that deal–pay-off or charge-off. The score itself means that over time you have a particular set of odds of winning (pay-off). Once you know the odds, you can appropriately price the deal. Attempts to cherry-pick credit based on items on the credit report only serve to degrade the odds.

Anything that can be observed by the naked eye on a credit report can be transformed in to an attribute that may be tested over millions of decisions in order to determine how that factor impacts credit performance. This is in essence counting cards in auto finance. A well-built credit score is customized to a lender's own dealer flow, with special consideration given to how the company services the paper.

Instead of credit analysis consisting of pre-approval guesswork, each aspect is systematically tested and refined over time. With a powerful credit score as the foundation, loan structure, stipulations, collateral, and other deal components are accurately matched to the appropriate level of risk. Using robust data and analytics, stage four companies are able to target and deliver very precise credit performance.

Conclusion

Auto decisioning is a well-established, well-proven innovation in auto finance. Companies successfully deploying such technology have benefited both through predictable performance and reduced operating expense, but it is predicated on the foundation of learnings that companies and executives gain over time. For lenders to be successful, they must have the following components in place:

• **Executive champion –** A senior leader with a vision for the future is the single most important factor to move forward. Transitioning from judgmental underwriting to a score-driven platform can be met with tremendous resistance. It takes the buy-in and backing of top executives to power through this change. Without it, the effort is doomed from the start.

• **Realistic expectations –** There are things the score is designed to do, and things it is not. The score allows the lender to order potential deals from highest risk to lowest risk. It does not protect against dealer or customer fraud. It will neither certify that the customer can afford the payment, nor will it evaluate the severity risk of the vehicle being financed. These factors must be carefully accounted for in any underwriting program, automated or manual.

• **Systems capability –** All of the strategy and analytics in the world cannot compensate for system limitations. Lenders must have a mature data warehouse, unquestioned data integrity, and the ability to easily query that data. Furthermore, the company's loan origination system (LOS) must be capable of not only auto-decisioning, but enough flexibility where the lender can respond in real-time by self-configuring changes. Unfortunately, many systems today are 1980's technology with attractive looking GUI overlays. For many lenders, all that is needed to move forward is to upgrade their LOS.

• **Expert knowledge –** Many people confuse reporting for analytics. Reporting is simply organizing and displaying information, whereas analysis is interpretation. As lenders grow, it becomes critical to invest in experienced credit analysts. These are people with both business and statistical knowledge, who can make sense of what works and doesn't in credit decisioning.

• **Controlled transition –** There are almost always unanticipated consequences to major change. When it comes from transitioning from a stage one to a stage two company, or making the change to complete automation, things happen. Managers can miss important details, dealers can change behavior, or your own people may passively sabotage change. For automated decisioning to be successful, it must be deployed in a very measured manner, with plenty of time reserved for follow-on analysis. Too much too fast is a surefire way to kill a good initiative.

Daniel Parry is co-founder and CEO of Praxis Finance, an auto finance company based out of the Dallas/Fort Worth area. He was formerly chief credit officer at Exeter Finance Corp, a company he co-founded in 2006, and senior vice president of Risk Management at AmeriCredit Corp.

Please direct comments or questions to danielparrynaf@live.com.