

Credit Scoring & Credit Control Conference IX

Impact of Regulatory Change upon the
Profitable Use of Credit Scoring Techniques

George Wilkinson
September 2005

Introduction

- Credit scoring is a key tool for making objective & profitable consumer credit decisions
- Use has expanded widely to optimise other key elements in the lending process
- Regulation has been benign and manageable – but government and consumer groups now seek to widen this
- Many agencies are ‘in on the act’ and UK and EC law facilitates more and more regulation – with over-indebtedness providing the springboard
- The control of the credit decision is at risk – with other parties seeking to direct its management
- Is there a problem? Are lenders at fault? Are we prepared to contest over-regulation? Can we defend our decision-making processes with objective data? Are we too passive – is the customer being treated ‘fairly’?

Regulators

- The cornerstone of regulation belongs to the Consumer Credit Act (replaced by the Consumer Credit Bill) and the European Directive on Consumer Credit
- Both seek substantially improved consumer protection – but this trend goes further and calls into question whether the customer is treated ‘fairly’
- The following sections take a light look at the players, but seriously at their roles and the implications
- There are regulations that are not so obvious too!

'Penny Prudent' - from the FO (Financial Ombudsman)

"My job is to check whether a financial institution has acted properly on individual cases and I can achieve rectification and compensation"



Lenders may have to anticipate the nature of decisions coming from the FO and build these into the lending processes. In turn they will have to defend individual decisions and the scoring process

Financial organisations become involved in discussions on individual lending decisions – and may have their actions reviewed

'Poppy' – of the Electoral Commission

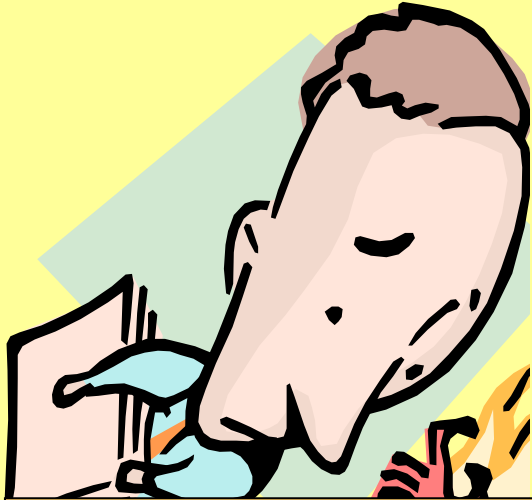


“My role is to make voting easier and more popular. But though the voters roll is helpful to lenders we may not always allow its use”

If the EC are so minded – and if they follow typical European practice – the use of voters rolls for verification may be prohibited. Credit decisions would thus be affected.

Costs and fraud can rise and increase the absolute cost of processing credit agreements

'Homer' - from the Home Office



“My job is to keep an eye on fraud and illegal practices and we have some sympathy with the credit industry on identity verification – but may draw the line on lenders using ID cards”

The Home Office was originally not very helpful in the debate over the use of electoral roll and appears to be only slightly helpful on use of identification cards

If voters roll use is restricted then individual decisions may be more fraudulent

'Tessie Toe' – from the TSO

“My job is to make sure that lenders follow the practices required from the Consumer Credit Act perspective. This includes advertising, APR calculations & whether collections follow best practice. Our role will widen too and we may be involved in deciding ‘fairness’”



If risk based pricing is used – if APRs are high for sub-prime lending products and if customers are not properly treated – TSO's can soon be part of a prosecution on specific matters – including lending processes

The powers of the Trading Standards Officer will be reviewed alongside the wider role of the OFT and could have an impact on how lenders operate and what they charge

‘Millie Mussels’ - from Brussels



“We have drafted European wide credit legislation to protect the poor customer from the unscrupulous lender. We cannot understand the big fuss and all the major changes the European lenders have wanted. The consumer is naked and the lender big and powerful. We are contemplating what to do with the latest CCD draft”

The industry’s resistance to the appallingly drafted CCD has borne fruit – for the moment. There is still a risk that individual lending decisions can be judged unfair and be overturned. Use of data in the decision has been queried but maintained – for now

If European legislation continues in its consumer protection mode then lending processes and individual decisions will be subject to both political and judicial scrutiny

'Nicky Seal' - from the NCC

"We now have the power to challenge any practice we don't like on the grounds that the customer is disadvantaged. We can refer straight to the OFT and if necessary they can instigate a competition enquiry. We have done this on sub-prime lending, home credit – banking charges and retail credit cards"



Individual products – markets and pricing mechanisms could be restricted or outlawed. There is a strong likelihood that the home credit and retail credit markets will be impacted

If the powers of the OFT and the Competition Commission are applied vigorously – drastic and detrimental changes to lending practice and charges will result

‘Willy Witch’ - from ‘Which’

“We have powers similar to the NCC and we organise and publish our own research on behalf of the consumer. It tends to show how badly managed the credit industry is and how it does not satisfy the customer and is only interested in massive profit generation. We will continue to pressurise on behalf of the consumer”



If this body – in combination with the OFT and others – decides to defend consumers in court on unfairness grounds – decision-making processes and individual credit decisions can be challenged

Which can influence government policy on particular products and is capable of refining the processes in the Consumer Credit Bill on unfairness. Unfairness has not been defined by the courts or anyone yet but some cases are coming to light - adversely

‘Atomic Fission’ from the Commission (Competition)

“We act on behalf of the consumer and seek to rectify any detriment caused by unfair competitive practice. We have the powers to change corporate activity in a significant way – especially if a monopolistic position exists”



At present bank charges – APRs for retail credit and home credit – structure of lending markets – the nature and practice of payment protection selling and pricing – and many other key areas are under review

Companies can be asked to stop lending practices – alter their APRs and early settlement routines – and restructure and possibly sell businesses

'Dr Willie Watson' - from the ICO

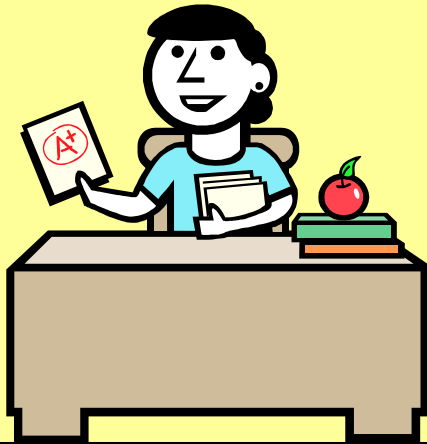
"We seek to offer a practical but rigorous approach towards data and are particularly interested in how the credit industry uses data to make credit decisions. We have made interim concessions on third party data use – and other elements such as the voters roll but will not necessarily maintain this. We will continue to look at how credit reference data is handled and processed and will re-examine guidance given in the past"



Credit decisions are currently made on the maximum amount of data but wider use of expanded data basis may not be easily granted. Even current decisions may be affected by stricter future interpretations

At any point in time more severe interpretations in data protection law – along the lines of the rest of Europe – can be applied and credit data use severely restricted

'Lucy Nice' - Citizens Advice

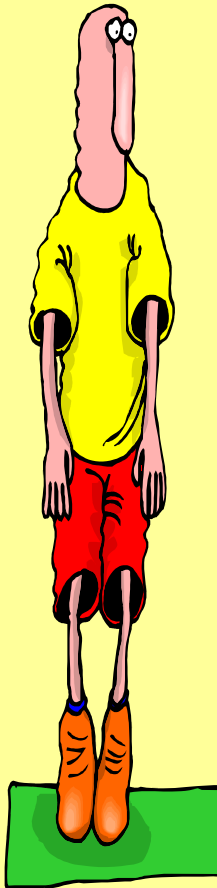


“We have been invited to share in the £45m to be granted to the money advice sector and will use this to ensure that lenders and their practices are satisfactory. We believe that massive over-indebtedness exists and that lenders are responsible for much personal family distress. We think lending is not properly controlled and may not be fair to the consumer”

If pressure on government from such organisations continues and their funding is maintained then in combination with others lending processes and individual decisions can be legitimately challenged

Lenders will have to take greater care in the amounts lent and the nature of research undertaken before the lending decision. Scorecards alone will not be enough nor will crude and unsubstantiated analysis of income and outgoings. The lending decision will become more cumbersome – costly – and possibly more subjective

'Harry High' from the DTI



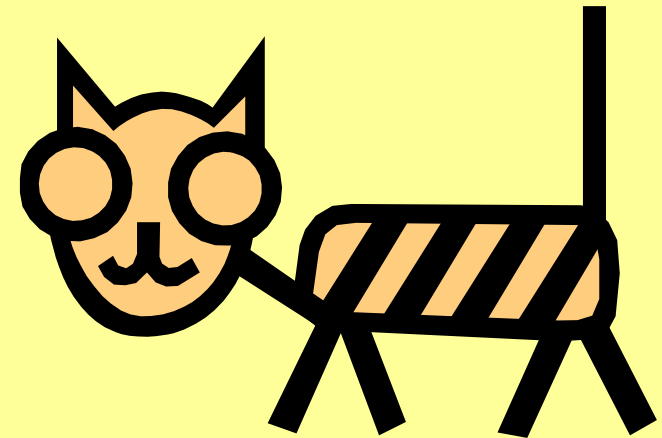
“We have the high ground as we are close to the government and have influenced the passage of the Consumer Credit Bill. We ensured that the OFT and others have more powers and will not hesitate to act to enhance them. We want to see significant change in customer decisioning by lenders to minimise over-indebtedness. We have assured MPs that the courts will have a high degree of influence on unfair credit decisions”

More and more individual credit decisions will be challenged as will the processes – including credit scoring – that are involved

Lending processes will be subjected to a fairness test – though fairness has not been defined. How will it be defined and what can the industry do? Is scoring good enough and is it defensible?

'Tiger Tee' from OFT

“The OFT – with its increased powers under the Consumer Credit Bill – and coupled with its existing powers – can substantially influence the whole process of lending and will be able to act”



Recently – guidelines were produced by the OFT on collection practices. These are not legal but the OFT has sought to have them enforced despite elements within them being impractical and unreasonable. There may be upcoming court cases to test this but collections scoring may be affected

With the Enterprise Act powers activities can be judged as unfair and be stopped – this could potentially put lenders out of business

'Freddy Slay' - from the FSA

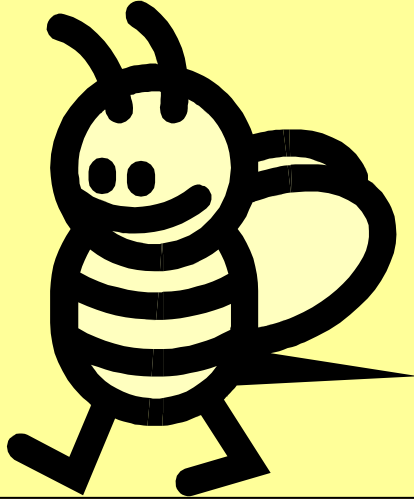


“We now effectively control the whole of the mortgage lending process and that of the insurance industry. We can act in a significant way on credit insurance in particular and will hand out substantial fines on the investment and other fronts where we are not satisfied with practices. We will eventually – we expect – have a greater involvement in unsecured credit and will lay down strict policies as before”

With its powers under banking supervision overlaid upon the increased regulatory powers – the FSA can drastically impact individual processes and even the scorecards themselves – Basle 2 has also widened their detailed interest and scrutiny

The FSA will increasingly be interested in and will influence lending decisions. This is already happening on mortgage lending and will put scoring and lending practices under the spotlight

'Busy Bee' - from the TSC



“The Treasury Select Committee has in practice a fairly free mandate to challenge any and every credit decision process. It has done so with vigour and will continue to do so”

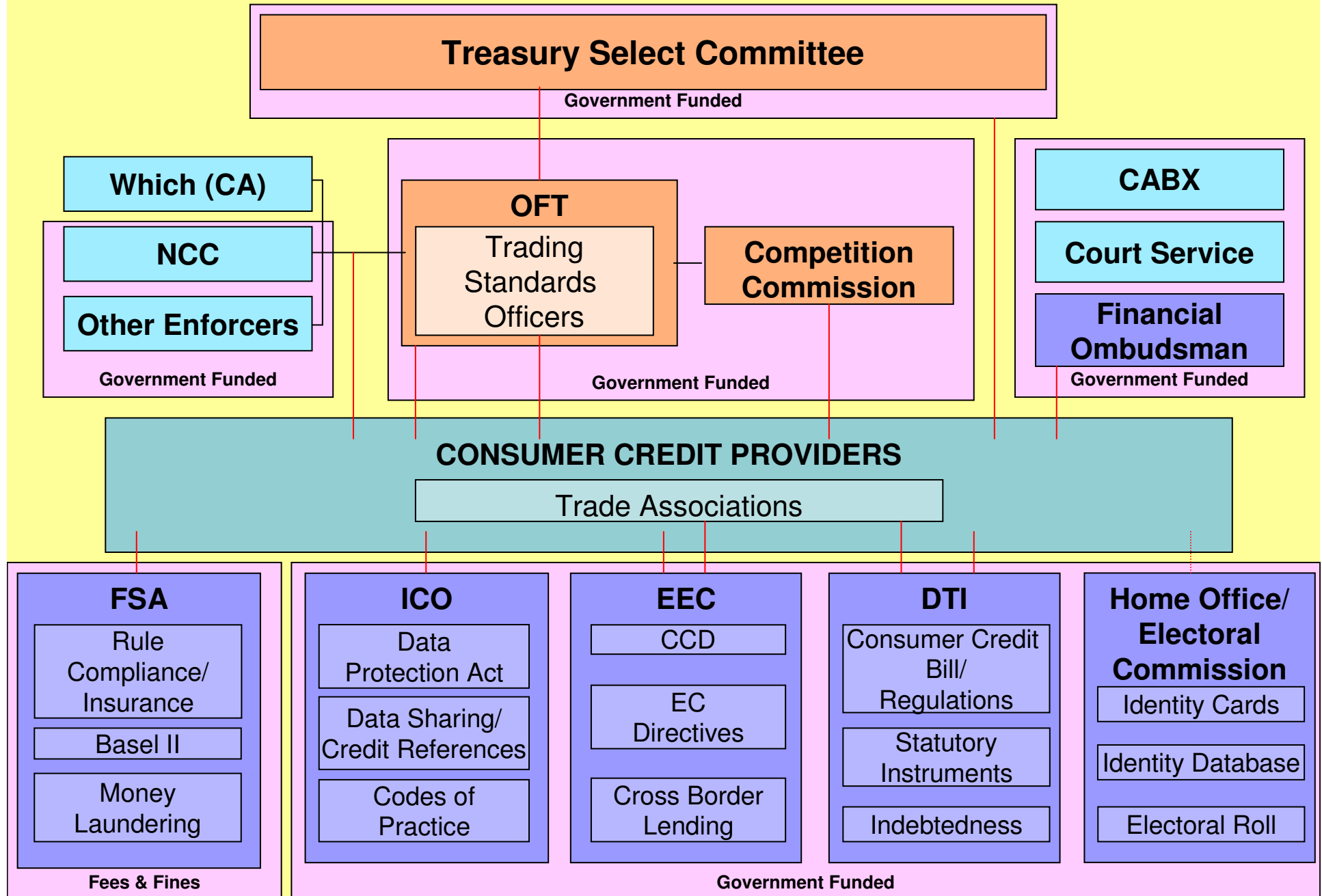
Even the OFT have been criticised and described as “comatose”. A parade of chief executives of major banks in front of the TSC has happened and such scrutiny will continue

Individual products – lending trends – interest rates – terms and conditions – customer treatment – and approaches towards data sharing and scoring will continue to be ‘picked over’ by the TSC. This will significantly impact on lending processes

Combined Picture

- The following chart indicates the significant number of players involved in the review and regulation of consumer credit
- Most – if not all – are very significantly funded by the government. In combination the amount runs into billions per annum
- The credit industry – through its trade associations – is probably under represented and under funded
- There is a risk that lending decisions will be controlled from outside the industry

Credit providers and regulators



Summary

- In essence, we become very dependent on the definition of 'fairness' – in lending decisions despite its not being defined anywhere
- It seems that consumer credit – from a government and regulator point of view – is now concerned with the following:
 - The growth in consumer credit,
 - Who gets it,
 - How much is granted, and
 - How much the customers pays
- These interests go to the core of the lending decision and the lending processes. Are we ready?