MEDIA RELEASE

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decision intellect

Credit scores require re-think

Global crisis places pressure on assessment processes

Australian lenders – bank and non-bank – need to review their credit scoring models in light of the global economic crisis or run the risk of higher bad debts and prolonging the credit drought currently being experienced by consumers and small business.

This is the finding from one of Australia's leading credit scoring experts who argues that many lenders are operating scoring models that were built on boom time assumptions and expectations which are now largely irrelevant.

Credit scoring has become a key element in credit assessment processes of most domestic credit providers and scoring is pervasive throughout the developed world.

Vaughan Dixon, Managing Director of Decision Intellect, argues that as credit scoring is relatively new in Australia the vast majority of scoring models have never been tested under a severe economic downturn. Furthermore, many credit professionals have never worked through a large scale economic crisis and are unsure of how to model the current environment.

Decision Intellect is Australia's leading credit scoring and decisioning company providing advice to major bank and non-bank credit providers. Decision Intellect also consults to the World Bank on a range of projects focused on developing credit reporting agencies and scoring systems in developing economies.

Mr Dixon believes that the assumptions that many models have been built on need to be immediately reviewed or credit providers will significantly miscalculate risk. The consequent rise in bad debt will likely see credit providers pull back from lending which will further exacerbate the credit drought.

"Scoring models are traditionally built on assumptions of the last three to five years. This means that many models currently in use which include macro-economic assumptions are no longer relevant," said Mr Dixon.

"Consequently, Australian firms are now facing a situation where they have no historic precedent to refer to for direction and where the rules that have been in place for some time no longer apply."

"There are a range of macro-economic factors that influence credit scores such as unemployment, cash flow projections, corporate risk ratings and consumer spending. All of these factors have changed dramatically and lenders that don't revisit these assumptions will end up with results that fail to account for this changed environment. The outcome will be a further rise in bad debt."

Credit scoring generally produces both a ranking of applicants and an odds ratio of default. Existing scores will still accurately rank credit applicants however the odds ratio will change dramatically.

"This means that while lenders will still be able to effectively rank applicants on a relative basis even those applicants that are ranked a lower likelihood of defaulting are starting from a riskier base. Accordingly, many applicants will be a much higher risk of default than they would otherwise appear if scoring models rely heavily on ranking and don't adjust their odds ratios", said Mr Dixon.

Mr Dixon's concern is based on the knowledge that many credit providers, particularly non-bank credit providers, often set and forget their scoring models leaving them in place unchanged for extended periods of time. Credit providers could get away with this approach in benign economic times but when the situation changes those models are not prepared to assess the significance of the changing data.

"Credit scoring is a sophisticated process that is of real benefit to both credit providers and consumers. However, their sophistication means they need to be monitored and reviewed. Those that fail to do so will pay the price in a rise in bad debt," said Mr Dixon.

The implications of the global economic crisis on credit scoring is examined in a whitepaper which examines the role of credit scorecards, the assumptions on which they are built, how new data can affect these scorecards and the steps credit providers can take to prepare for the new environment.

For further information or comment please contact:

Damian Karmelich
Director – Marketing & Corporate Affairs
Tel. (03) 9828 3233
Mob. 0407 772 548