Point of View

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Custom Rates Can Reduce Risk, Give You an Edge in a Competitive Market

In today's auto lending market, there is more data available than ever before for making credit and pricing decisions. Lenders don't have to rely on FICO-based pricing or custom scorecards to determine the credit risk in a deal and the appropriate rate for a borrower. The fact is those score-based methods may no longer be the most effective ways to accurately price for credit risk or to win new business. Deal-level pricing offers an alternative that could give lenders greater accuracy in assigning rates and better leverage in a competitive market. That method lets lenders price each deal on its individual risk while avoiding some of the drawbacks of score-based pricing.

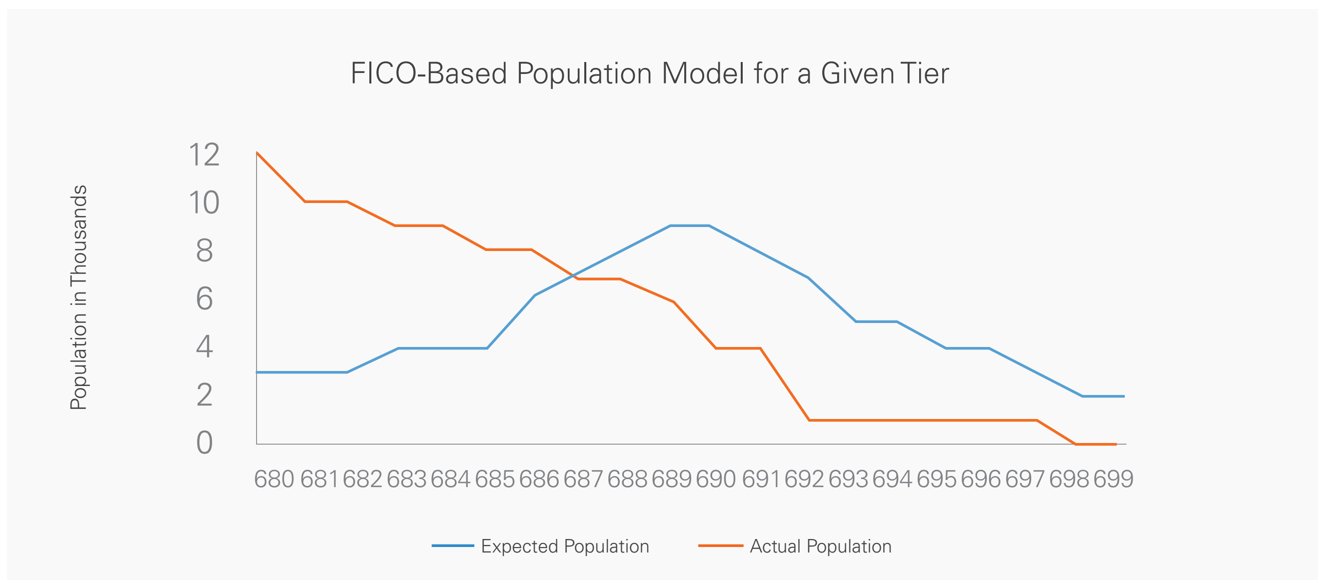
It should come as no surprise that rates are important factors when borrowers are choosing a lender. But that's even more prevalent today, according to 2017 consumer trends research from Fiserv. In the Expectations & Experiences: Borrowing and Wealth Management survey, 83 percent of consumers who have a loan said rates played a role in selecting a lender. That's an increase from 76 percent in the 2016 survey.

Deal-level pricing can help lenders meet those borrower expectations by assigning a custom rate. But understanding the benefits of that approach starts with a breakdown of the traditional methods.

FICO Modeling: Adverse Selection

FICO is probably the easiest pricing model to deploy because all it requires is a credit bureau score to assess risk and assign the corresponding rate. It's easy to publish on a rate sheet and lets dealers quickly estimate rates because borrowers are bracketed into a FICO-based tier.

But there is a big downside to the approach: adverse selection. The reality is that no matter how narrow the score tiers, you are going to get a disparate percentage of deals that fall into the lower end.



Most models use a blended rate based on an assumed population curve to account for risk within the tier. But if the actual population is heavy on the low end of the FICO range and light on the high end, the resulting performance curve will not match projections, and the lender will incur higher losses than expected.

Those on the lower end of the FICO range will more likely default, while those on the higher end could get a better rate elsewhere. Lumping a wide range of borrowers into the same rate isn't good for risk or business.

The Custom Score: Predictive but Inflexible

Many lenders build internal scorecards using traditional credit bureau attributes such as credit amount or number of satisfactory trades. The lenders then layer in such other attributes as collateral age, term or loan to value (LTV).

It's common for those lenders to deploy multiple custom scorecards to different segments of the borrower pool. The custom score is then used, typically in conjunction with the FICO score, as the basis of the decision model. Those cards are attractive because they are more predictive of the credit risk for a particular population segment than if the lender used a FICO-only method.

While custom scorecards let lenders asses some premium for risk that, in turn, feeds the pricing model, the tools are not very flexible. The scorecards require data, analytics, data scientists, and time to develop and vet.

The process typically takes months or even years to complete, and that puts lenders on a three- to five-year cycle of deploying new scorecards. That makes it difficult for lenders to change scorecards quickly enough to respond to evolving market conditions.

The Scoring-to-Price Conundrum

Traditional tiered pricing derives from FICO-driven score models, custom scorecards or variations of the two. That pricing typically assigns a rate for a given credit tier and then allows for adjustments based on such factors as term, model year or LTV.

The traditional approach results in relatively simple pricing so dealers can give customers a rate on the spot. But it still falls short of truly pricing for risk and might not be as relevant now that technology is increasing the frequency of auto-decisions.

Typical Dealer Rate Sheet

		Credit Tier		
Model Year	Term	Tier 1	Tier 2	Tier 3
2017	60	2.9%	3.9%	5.4%
2017	72	3.9%	4.9%	6.1%
2017	84	4.4%	6.2%	N/A

Add .25% for LTV higher than 110%. Deduct .25% if amount financed is more than $25,000

Using traditional pricing, a lender cannot precisely account for a deal's risk complexity because the scores are a composite, rather than specific, value. Additionally, among the components that make up an interest rate are offsets for such elements as cost of funds, operations and originations expense, time value of money, dealer reserve and risk premium.

Those components vary depending on the deal. Originations and servicing expenses, for example, are higher on a nonprime deal, while dealer expense from flat fees is typically higher on a prime deal.

Score-based models simply cannot account for all of the aspects of a deal that add risk.

Deal-Level Pricing Presents a Strong Alternative

The traditional methods of evaluating risk are still common among lenders, but the drawbacks are clear. Deal-level pricing, however, focuses on each deal's unique structure, collateral and credit-risk attributes. The approach, while more complex, precisely assesses the performance, risk and cost components for a given application and then accurately prices that deal.

In a deal-level pricing model, attributes are assessed individually as part of a total deal. The rate reflects minute changes in attributes as their values change relative to other attributes' value changes.

Deal-level pricing lets lenders build models that account for unique rates as the LTV increases, the amount financed decreases and the term gets longer. That approach typically results in multidimensional models that far exceed the complexity of those created when custom scorecards or FICO-only scoring drive pricing.

The models are hyper-accurate when compared to an average of blended values and are generally built on the same empirical data driving custom scorecards. But instead of adding score values for attributes into a general custom score that drives a blended rate, the statistically relevant ranges may be accounted for directly from a pricing perspective. The result is that each deal is priced based on its unique merit and risk.

The models are also more responsive to market changes. For example, if a lender feels exposure is increasing on longer-term deals, it's easy to increase the term premium by 25 or 50 basis points to offset the risk. It's not necessary for the lender to rebuild, test and redeploy credit-risk scoring models to account for the condition. The lender can correct the situation within minutes of identifying it.

Sample of a Deal-Level Pricing Model

Tier	Vehicle Age	Term Low	Term High	Advance Low	Advance High	Payment Ratio Low	Payment Ratio High	Amount Financed Low	Amount Financed High	Rate
1	0	0	48	0	49.99	0	5	0	18000	2.54
1	0	0	48	50	54.99	5.01	10	0	18000	5.56
1	0	0	48	55	56.99	10.01	11	0	18000	2.61

Find the Method That Drives Business

The auto lending market continues to evolve, but there are two constants: Competitors are always looking for an edge, and borrowers are always looking for the best rates. Your success depends on how well you stay ahead of the former and meet the expectations of the latter.

Deal-level pricing is a tool that can help you achieve both goals. It enables higher auto-decision rates, better credit-risk analysis and more precise pricing models. Taking advantage of that tool can help you increase margins, offset losses and manage risk.

About the Author

Scott Hendriks has more than 20 years of experience on both the lender and service provider sides of the consumer finance industry. He spent 10 years in the mortgage lending, consumer lending and indirect automotive lending segments of the market, originating receivables both for prime and nonprime portfolios. He worked in many areas of credit operations, including credit management, risk management and compliance. Since joining Fiserv in 2002, Hendriks has been involved in the development of the Auto LOS product and now is the director of product management for Auto Originations.

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For more information about deal-level pricing, call 800-872-7882, email getsolutions@fiserv.com or visit www.fiserv.com.

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