Comment: Evaluative Techniques in Consumer Finance--Experimental Results and Policy Implications for Financial Institutions

Mark Nelson

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COMMENT: EVALUATIVE TECHNIQUES IN CONSUMER FINANCE--

EXPERIMENTAL RESULTS AND POLICY IMPLICATIONS FOR FINANCIAL INSTITUTIONS

*Mark Nelson**

The Apilado, Warner, Dauten paper is notable in several respects. The problem of credit worthiness in consumer credit is certainly critical in our credit-oriented society. The research design is innovative and shows considerable thought. The paper's conclusions are modest, yet they do represent some progress in attempting to quantify the consumer credit-granting activities of financial institutions. This review of the paper will concentrate on two areas--research design and a broad discussion of the paper's practical applicability.

The objectives of the paper appear to be "the predicting of good and submarginal risks prior to the granting of credit, and the attaining of optimal credit acceptance policies." The first objective was pursued by empirical research and the latter by an opportunity-cost model.

The empirical study utilized data gathered from loan applications. The sample included 475 "good" loans and 475 "bad" loans. The data were categorized as reflecting character and capacity. Collateral is excluded as a separate area. The authors devote an entire paragraph to justify this exclusion. In doing so, in this reviewer's opinion, they serve to perpetuate the belief that collateral gives little indication of a debtor's credit riskiness. Personal research of the reviewer on bankruptcies has shown that the ratio of personal assets to personal debt is the greatest single factor separating those who go bankrupt from those who do not. In order for a person to develop good collateral, some financial restraint and judgment must be used. Even those who inherit collateral must conserve it or at least not squander it foolishly.

The results of the data analysis in the paper provide some confirmation for the above conclusion. In both the univariate and multivariate analysis, home ownership was the greatest single factor predicting credit-worthiness.

The authors tested the results of the research by attempting to predict whether the loan would be good or bad on the basis of four selected variables. The model was correct in discrimination almost 75 percent of the time. This, the authors implicitly concluded, was better than the judgment of loan officers, who approved the loans. Fortunately, it is somewhat certain that the officers had to grant considerably more than 950 loans in order for 475 bad loans to occur. In fact, any loan officer whose ability to discriminate between good and bad loans is less than 98 percent accurate is soon replaced. In this respect, the quantitative model still has much to improve if it is to replace the often qualitative judgment of the existing loan officers.

Weber State College.

The above observations still do not depreciate the value of the study. The reviewer has seen and participated in the development of credit scoring systems in financial institutions. This study is by far the most exacting in the selection and testing of variables having affected credit worthiness.

The paper's second objective of assistance in attaining optimal credit policies is not pursued with the standards of the methods used in meeting the objective of the prior section. The model proposed is considerably less sophisticated than the cloak of algebraic formulation makes it appear. These types of models for credit granting have been in used for several years in the development of trade credit policies for firms. The use of the model, as proposed by the paper, will probably at best serve to crystallize the thinking of financial institution policy makers. To this extent, it may be useful.

The paper's practical applications are limited. The research design excluded the loan officers' major criteria of character--prior bill-paying behavior. By including only those variables that are on the typical application, the usefulness of the model derived is mostly academic. Very little consumer credit is granted, by sole reference to the loan application. One or two trusted outside credit references generally are considered more valuable than the data on the loan application. Although admittedly difficult, a follow-up study that includes "outside" references as variables to predict credit worthiness would improve the paper's usefulness to financial institutions.

Profitability studies as suggested by the paper are difficult for two reasons: the elusive concept of "profit" in a financial institution, and the link between the lending and deposit activities of a bank. A credit rejection and later acceptance by a competitor will likely mean the loss of a deposit account.

In conclusion, the credit worthiness model proposed by the paper is a considerable improvement on early models. But much needs to be done in the inclusion of outside variables and in the improvement of predictive ability before such models become a practical and useful device.