A Meritus case study

MANAGING RISK IN THE RETAIL BANKING SECTOR

Retail banks rely increasingly upon automated credit score mechanisms at the point of lending to enable them to manage risk and lend appropriately. Meritus' analytics partner, Covansys, recently demonstrated the Application Scorecard using real data for a large public sector bank in India that had begun to generate significant growth in retail lending. The bank felt a need for enhancing its existing processes at the time of credit initiation to support its swift expansion into the retail banking sector.

Using a combination approach called CRM² (**© Covansys 2005-2006; Compliance and Risk Management Analytics Offerings from Covansys. CRM^{2} is a proprietary construct of Covansys; Service Mark registration pending**) a proprietary construct developed by our Analytics partner, it was demonstrated to the bank on how to improve risk modelling and simultaneously understand its customers better for marketing insights while continuing its swift expansion into the retail banking market.

Multi-geography road test

The introduction of an Application Scorecard to map current loan applications and compare them to the characteristics of past loan defaulters was proposed. This would allow the bank to estimate the probability of loan default.

Our analytic partner proposed a 'road test' to demonstrate the concept using real data. The sample selection was done in a systematic manner in order to reflect the representative nature of the retail asset portfolio of the bank both in terms of geography and the choice of loan products for the Application Score carding. Default was defined as 90 days past due payment for this exercise.

Different models were constructed for the different retail lending product categories using a subset of the sample.

The data was cleansed and data modelling was used to determine Probability of Default. Application of the model was to score a loan applicant's Probability of Default (PD). This was validated by back testing on the full sample set to determine the prediction accuracy.

The interpretation of the models revealed several key business insights.

The following recommendations were also made to the bank.

1. The bank can define its prediction rate threshold and once it falls below this level the model should be reviewed and maintained.
2. Demographic data captured should be the most recent in order to improve the accuracy of the models.
3. The bank can also take advantage of our Analytical partner's several Credit Risk Analytical Offerings such as an early warning system and risk-based pricing.

Reaping the benefits

Application scorecard is a robust and scientific tool for credit initiation in retail lending. The scorecard acts as an effective decision support system when considering loan applications and also leads to a potential reduction in loan losses for the bank by capitalising on the actionable insights provided by historical data.

The CRM^2 combined approach, using Customer Relationship Management to offer marketing insights and Credit Risk Management to help the bank identify risk potential at the point of lending, offers many benefits. In the highly commoditised retail lending sector, the bank has a key differentiator and is able to achieve its desired levels of loan distribution across a range of risk ratings and to use risk-based pricing more effectively. This will lead to an expected enhancement in asset quality over a period of time and improve the overall strength of the business by maximizing the risk adjusted profitability.