Signet Jewelers: Sources Suggest ADS May Tighten Credit Standards, Causing Zales Second Look to Result in Extension of Credit to Less Creditworthy Borrowers

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Update on Signet's Second Look

Signet Jewelers' transition of Zales to Alliance Data Systems (ADS) as the third-party credit provider took place in January. In connection with the transition, Signet's own in-house financing team will serve as the second look provider for consumers who did not otherwise qualify for credit through ADS.

Signet has already experienced downward pressure on its receivables portfolio due to a mix-shift in the Sterling Jewelers' division customers who are opting for in-house credit. With ADS' loss rates expected to increase through 2016 and begin to level off in 2017, ADS may increase its minimum scoring requirements, which would result in ADS denying credit to less creditworthy Zales' customers. With ADS likely to tighten its credit standards, Zales may have to manage even more loans from low credit-quality borrowers.

To provide additional clarification of how this shift in credit will work, we visited a Kay Jewelers store where we took a photo of the Kay credit application, and we further visited a Zales Jewelers store to speak with sales staff. For this article, we also spoke with John Ulzheimer – a nationally recognized credit expert and president of The Ulzheimer Group – as well as Travis Tuss – the Senior Vice President of Sales and Marketing at Zoot, a decisioning service provider – and other sources on background.

Alliance Data Systems Loss Rates Increasing

Alliance Data Systems recently released its Q4 results. During the conference call, ADS representatives discussed the fact that its actual loss rates were "drifting upwards." Indeed, ADS indicated that during the post-recession period it was actually recovering 35 cents on the dollar, and the amount is beginning to now normalize to the 20s, and the company expects to net out in the low 20s. In addition, the company expects loss rates to increase through 2017 when it then expects them to begin leveling off.

Importantly, ADS notes that the long-term normalize loss rate before "the great recession" was about 6.5%, and it expects the rate in 2017 and 2018 to level off at about 5.5%. It attributes the decrease to the fact that over the past several years it has attracted a higher quality type consumer from a credit perspective – including Barney's, Talbots and Bon-Ton – and has some co-branded cards in the mix, which carry a lower loss rate. More recently, ADS provided an update on its Card Services segment. According to the update, the delinquency rate as of January 31, 2016 was 4.5%, compared to 4.2% one-year earlier.

According to our sources, the increasing loss rates and increase in delinquencies by ADS could result in ADS having stricter underwriting policies before extending credit, particularly when it attributes a decrease in its overall loss rates to the increase in the quality of its customers. Specifically, John Ulzheimer noted that "generally speaking, credit card issuers and creditors in general who are trying to get a better grasp or better grip around their defaults or risk are going to increase their minimum scoring requirements, which means they will shut the door on people who are higher risk and only do business with people who are going to achieve a higher credit score range." This approach, according to Mr. Ulzheimer, while good from a credit risk perspective, was bad from a marketing perspective, and would result in fewer people being approved for Zales financing by ADS.

Our Visit to a Zales Store

The Capitol Forum visited the Zales store in Pentagon City Mall in the Washington, D.C. metro area. The employee at the store indicated that Zales no longer uses paper credit applications, but simply scans customers' ids in the system to see if the customer qualifies for credit.

The employee also informed us that when we apply for credit, we should apply in store because the online system only uses Comenity Bank – a unit of ADS, but in-store, our application would also be run through the in-house financing system in the event that we did not qualify for credit through Comenity Bank. If the customer did not qualify for credit through Comenity in store, they would receive a 12-page credit agreement through Zales' in-house financing arm, and the customer could decide whether to accept those terms. We were not able to see the terms of the financing offered by Zales in-house financing arm.

The employee also indicated that by applying in-store we would receive better financing options, which included better rates and more money. Also, the employee indicated that if we were at all concerned about not qualifying for credit through Comenity online, we should apply in-store because we were more likely to be approved. This is largely in line with a company's desire to never say no to a customer who was in the store and wanted to buy something. Although the online standards may be more rigorous, it appeared that Zales would be more willing to work with a customer in store, and the in-store customer would be more likely to qualify for credit than someone who simply applied online.

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We spoke with Travis Tuss, Senior Vice President of Sales and Marketing at Zoot, about credit decision engines at in-house financing operations. According to Mr. Tuss, lenders provide his company, Zoot, and other credit decisioning service providers with the necessary metrics under which those lenders are willing to extend credit. When a consumer goes to a store and provides basic information for a credit application, that information is transmitted to Zoot, which pulls credit reports and other information to determine whether the consumer qualifies for credit under the lender's standards. Zoot then sends information to the prospective issuer of credit to let them know whether the consumer has qualified for credit. The whole process takes a few seconds.

In the case of the second look for ADS, Mr. Tuss believes the whole process would be straightforward. If the consumer were denied credit because they failed to meet the ADS requirements, the application would be passed along to Signet Jewelers. If the consumer satisfied Signet's standards, credit would be extended. If not, the consumer would not receive credit. Indeed, in the credit terms provided by ADS, the document expressly provides that "I also agree that this application/solicitation and any information I submitted with it may be forwarded to other creditors," which enables ADS to pass along the information in the event that a customer does not meet ADS' standards.

In the case of Zales, even though the consumer may not meet the higher credit metrics or standards established by ADS, they could meet Signet's credit standard. According to Mr. Tuss, there is a real desire for retailers to never say no to a consumer who is in a store and who wants to buy something. In addition, Mr. Tuss notes that it is easier for Signet – which will generate revenue and realize the margins from both the sale of the product and the financing, as opposed to ADS which just gets the margin from financing – to decide to extend credit to a riskier borrower.

Mr. Tuss believes that Signet may introduce other jewelry-specific factors into the formula it uses in deciding whether to extend credit. Indeed, at a Signet investor conference, Signet CFO Michele Santana stated that the in-house credit division uses a proprietary model that uses many of the same tools financial institutions use to extend credit, "but the real value add is that our model layers on top of that a history of how borrowers have behaved in the repayment of loans, specifically for jewelry."

We are interested in better understanding how Signet acquires and collects additional information that would improve its proprietary model. Since the credit application itself is fairly limited in the information requested, Signet likely would have to draw on previous customer information and/or information acquired by third parties.

While we do not have insight into the precise FICO scores or other metrics that Signet considers when extending credit, CreditKarma data suggests that customers claim that they are unexpectedly approved for Kay's in-house credit more frequently than they are denied. However, stakeholders should note that Signet changed its decision engine in fiscal 2015, and data from CreditKarma includes reviews that pre-date the new decision engine.

Although we were not permitted to leave the store with a copy of Kay's credit application, we did take a picture of the application. The information Kay asks for includes: a customer's driver's license number, total monthly income, employer address, and a customer's length of time at an employer.