



It's All About Dollars at Risk

More than Models Are Needed to Evaluate Portfolio Risk Today

By Richard Openshaw

Nervous consumers are traumatized by their dwindling retirement assets, shrinking home values, and job losses. Many are dramatically cutting spending and juggling their monthly bills to stay afloat.

Card issuers are spooked, too. For years they have been using bureau scores and risk-based pricing to acquire new cardholders. It was a numbers game that worked when loss rates were 3 or 4 percent. But the charge-off rate rose to 7.74 percent in January 2009 and may reach double-digit figures before the end of 2009, according to Moody's.¹

In response, some issuers have reacted to short-term performance results by raising annual percentage rates (APRs), reducing credit lines, and increasing fee structures on accounts through the use of a non-targeted, broad-brush approach. While such "batch type" programs can be implemented quickly and cheaply, they more often than not damage issuer relationships with good accounts, while failing to weed out all the risky ones.

For example, reducing credit lines of long-term account holders can backfire if the affected cardholders decide, "If I can't use it, I won't pay it." Reliable cardholders may be alienated as well, taking their business elsewhere. We urge issuers to take special care in the way they treat existing customers. When cardholders' financial circumstances improve, they will likely be most loyal to those issuers that were loyal to them.

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RETURN TO JUDGMENT

In this challenging environment, bureau scores and long-standing risk models are no longer up to the task. Just as many financial institutions “outsourced” their risk management by relying on ratings agencies to evaluate their investments, many card issuers were too dependent on credit scores in evaluating cardholders. Issuers should reevaluate their scores to identify the factors that are driving some cardholders to delinquency so that they can develop and offer appropriate treatments. Issuers experiencing deterioration need to adjust cut-offs and rebuild or develop supplemental models to augment what they currently use.

In addition, banks need to view customers through a sophisticated and holistic profitability framework that accurately identifies their “best customers.” The goal of delinquency management should be to keep cardholders as customers whenever possible, of course. The challenge: how to maximize collections without unnecessarily turning accounts into charge-offs or otherwise alienating those cardholders who still have the potential to remain valuable customers in the long term.

To do that, you need to consider additional information: customer employment, income, residence, length of residence, number of cards owned, and payment history of utility bills.

Then factor that information against market data for your region, such as foreclosure or charge-off rates, jobless rates, and other data. Each cardholder cohort is unique and requires a different approach. A group of delinquent customers who have broader relationships with the bank, for example, should receive preferential treatment over delinquent cardholders who use only one of the bank’s products.



BENCHMARK YOUR PERFORMANCE

How do your payment percentages compare to the national average? Your region? Your peers? It’s all about dollars at risk. Closely monitoring customer behavior is critical now, given the greater likelihood of late payments and delinquencies. Changes in spending up or down may be good or bad news. If a transactor becomes a revolver, or if a cardholder suddenly starts paying half of what he or she used to, or only the minimum, that may mean trouble. Here’s an example: One customer has a \$6,000 balance 30 days past due and another customer with a \$2,000 balance is only five days past due; can you guess who is the greater risk? The point is that you need more information about your customers to answer the question. The cardholder who is 30 days past due may be exhibiting typical behavior, whereas the customer who is only five days late may have been an on-time transactor for years—until now. Changes in payment patterns are what should sound the alarm bells, not outstanding balances themselves.

Previously profitable segments have become unprofitable. Some issuers, in pursuit of “affluent” customers, believed they could use spend or transaction data as their filter. Those high spenders were making good payments, but when their home equity disappeared, they fell behind. Here again, issuers need to look at other factors to more accurately define who is truly affluent, or who might appear affluent but is actually operating a small business—and should receive a different marketing approach. At a minimum, we recommend reviewing authorizations weekly and payment data monthly. In addition to the usual factors portfolio managers track—origination quality, account maturation, seasonality, and management actions—we recommend you pay attention to such macroeconomic factors as unemployment, housing, and retail spending.

Only by applying new frameworks, deeper data, and insights can you decide which segments you wish to continue serving. Other segments that no longer provide value need to be managed down and off the books. And communications with customers should be a two-way dialogue. By encouraging customers to reach out to you, to call for help before things get unmanageable, you are likely to retain more of the cardholders you want—and avoid them “bad-mouthing” you to friends and family.

FINE-TUNE CREDIT LINE MANAGEMENT SYSTEMS

Managing the credit lines of your customers requires more complex analysis than simply employing industry-average line levels. Line adjustments should continually be tested, using customer segments that identify need, appetite, capacity, and risk level. Doing so should stimulate higher card activation and usage, generate positive risk-adjusted return on the portfolio, and mitigate liability exposure in a changing credit market.

We recommend issuers use advanced analytics and segmentation techniques to conduct a thorough review of all of the company's risk-based pricing strategies—with an eye to determining the impact they are having on cardholder behavior. Carefully evaluate loss and attrition rates, as well as delinquencies. Using customer spending and payment histories, in combination with credit bureau data, devise strategies and payment elasticity models to fine-tune pricing adjustments. Then apply the new criteria and business rules to a sensitivity model. All of these steps should help reduce both account attrition and forced charge-offs.

REGULATIONS AND LEGISLATION LIKELY TO RAISE THE COMPETITIVE BAR

Policymakers around the world are looking at ways to protect consumers given the current economic crisis. In addition, the Basel II framework, which requires banks to better assess risk and increase capital reserves, is due to be fully implemented in 2010 in most of the world. The largest internationally active banks in the U.S. will enter the first transitional period this year and reach full implementation in 2014.

The challenge for issuers is that regulations and legislation affecting current practices will increase the cost of doing business and likely raise the price of credit. As JPMorgan Chase CEO James Dimon observed, "If you can't reprice certain loans, you are not going to make certain types of loans. If you have to have people pay off teaser-rate loans last on a series of loans, we're not going to make teaser-rate loans... we're going to run the business for profit. If outstandings go down \$10 billion, so be it."²

When new regulations go into effect, or if legislation affecting issuer practices is passed, issuers may have to rethink pricing for some segments of their portfolios. But if the value proposition is compelling, cardholders may willingly pay for access to credit—just as they pay an annual membership fee to shop at Sam's Club. Rewards programs will also likely need revamping to ensure audience appeal and issuer profitability. Finally, terms and conditions will probably need updating, so issuers can exercise greater control over, for example, when they reissue cards. Less-profitable customers might be issued cards with only 12-month expiry dates versus 48 months for more profitable customers.

CHOOSE ACCURACY OVER SPEED

Now is the time for issuers to review segmentation models and employ statistical tools to identify cardholders with the greatest propensity to remain profitable. It's unlikely that the older risk models some issuers still use are effective at identifying which customers are or can be truly profitable, and which should be transitioned off the books. Meanwhile, issuers should fine-tune pricing models and proactively identify the riskiest accounts in order to keep the best customers, maximize collections, and avoid rising charge-offs. Using this approach, issuers can balance portfolio growth against risk to come out ahead, increasing profitability even in these challenging times. ●

1 Moody's Investors Service, Global Credit Research, February 27, 2009.

2 Harry Terris, "Card Issuers' Issues: Credit, Funding, Regs," *American Banker*, October 20, 2008.



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