

Not All Credit Card Borrowers Are Created Equal

••Borrowers in trouble fall into one of five categories. Banks can cut their credit card write-offs by placing these customers in the right groups and treating them accordingly.

BY ARNAB GUPTA AND PHILLIP RIESE

PANICKED BY THE prospect that credit card defaults could rival those of the mortgage meltdown, banks have pared almost \$1 trillion from credit lines since the peak of the credit boom. They are taking wholesale adverse actions and initiating aggressive recovery programs against borrowers at an unprecedented rate.

Our analysis says this is the wrong path to take. It can hurt lenders in several ways by:

Alienating valuable relationships and driving the best customers to competitors.

Misjudging or overlooking creditworthy customers who can responsibly use—and deserve—higher credit limits.

Overspending in an attempt to collect debts that can be recovered through less costly means or that have little chance of being repaid even after aggressive recovery efforts.

The problem is that not all credit card customers are created equal. They differ both in their ability and their willingness to pay. Moreover, most banks are working with

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credit models that were designed for more stable times, relying on data that goes back several years. Today, a customer's situation can change dramatically in only a few months.

To manage in these times, lenders need a more timely, accurate, and relevant picture of where each customer stands. First, they need this information so they can determine when and how to reduce the risk that a borrower will become delinquent. Second, if a borrower moves to





customer's situation, comprehensive enough to integrate relevant new metrics, and discerning enough to distinguish among different types of borrowers and defaulters.

Bad Times Call for Better Credit Models

We have increased predictive accuracy 15–25% by changing the analytical techniques we apply, the data we use, and the way we combine the outputs of our models to arrive at better aggregated discrimination. For example,

we use neural networks and nonlinear techniques that look at relationships among a larger number of complex variables to better segment the customer base. In addition to economic factors like changes in employment status or real estate values, we overlay variables such as transaction data by size, type, and merchant category; utilization rates; and relationship factors like tenure, number of products, and profitability to create a picture of the customer's true value.

These models enable us to distinguish those customers who can manage increased credit from those who bear more careful watching, and to find which customers are solid and which are in danger of default. Moreover, they allow us to determine the type and level of intervention that would be most appropriate, both before and after default.

Fine Distinctions Make Big Differences

Although these new models make distinctions very finely at the individual consumer level, we have been able to identify five basic types of borrowers. Being able to tell which is which can make a difference of as much as \$200–500 million to a large lender.

1 False Negative—These are customers who can handle higher credit lines—and deserve them—but who have been

delinquent, they need to know the steps required to maximize not only collections, but also the probability that delinquent borrowers can again become performing, paying, and loyal customers with the minimum amount of adverse action.

Over the past year, we have been working with major banks and financial institutions to develop credit models that are nimble enough to incorporate rapid changes in a

Figure 1

The Five Basic Debtor Types.. And How To Handle

	<u>Borrower Characteristics</u>	<u>Recommended Actions</u>
1	False Negative 2/3 of credit-worthy borrowers are misidentified by obtuse credit models	Nurture and develop, possibly with higher credit lines
2	On The Edge But Not Over Red flags in the profile, but no default	Watch and evaluate carefully, factor long term customer value into risk model and manage on a case-by-case basis
3	Recoverable 20-25% are responsible borrowers who have defaulted but would repay if they could—and will when they are able	Customize recovery solutions to their specific situation
4	Dry Hole 34% of customers default and will never, ever pay anything	Don't waste time or money drilling "dry holes." Close the account and send directly to third-party collections
5	Just Need a Nudge 20% will cure on their own with minimal intervention	A letter or text message will be just as effective as an expensive collection call. But remember, less is more: keep the tone respectful

misidentified by obtuse models that can't distinguish among different types of borrowers.

Our analysis shows that two-thirds of recent credit actions have impacted what are generally the most financially responsible consumers—those with a median FICO score of 770—often because of a vicious cycle that starts with one lender taking a single adverse action. Why? Because 30% of one's FICO score is based on the utilization ratio—the level of a person's debt relative to available credit. One cut in a credit line increases the utilization ratio, decreases perceived creditworthiness, and triggers cuts from other lenders, all of which increase the utilization ratio further. In the absence of sophisticated models, these borrowers' assumed creditworthiness in the market begins to spiral downward, even though their basic behavior and creditworthiness have not changed one whit.

These borrowers represent a missed opportunity, or worse. Instead of alienating these customers and exposing the business to even more **franchise [same as "enterprise"?**] risk, the appropriate strategy would be to nurture them, potentially with greater credit lines, and ultimately win market share, long-term loyalty, and profits.

2 On the Edge, But Not Over—These are customers whose profiles change in a way that throws up a red flag, but who have not yet defaulted.

The key questions for this group are when to act and what

action to take. In today's environment, when a borrower's credit data raises a red flag of any kind, it's good practice not to wait until the customer becomes delinquent before taking action. On the other hand, this red flag could be a false negative, and adverse action against a good customer, particularly one who is not in delinquency, is a breach of trust that's difficult to repair. It drives customers to competitors, ruins brands, and kills performance.

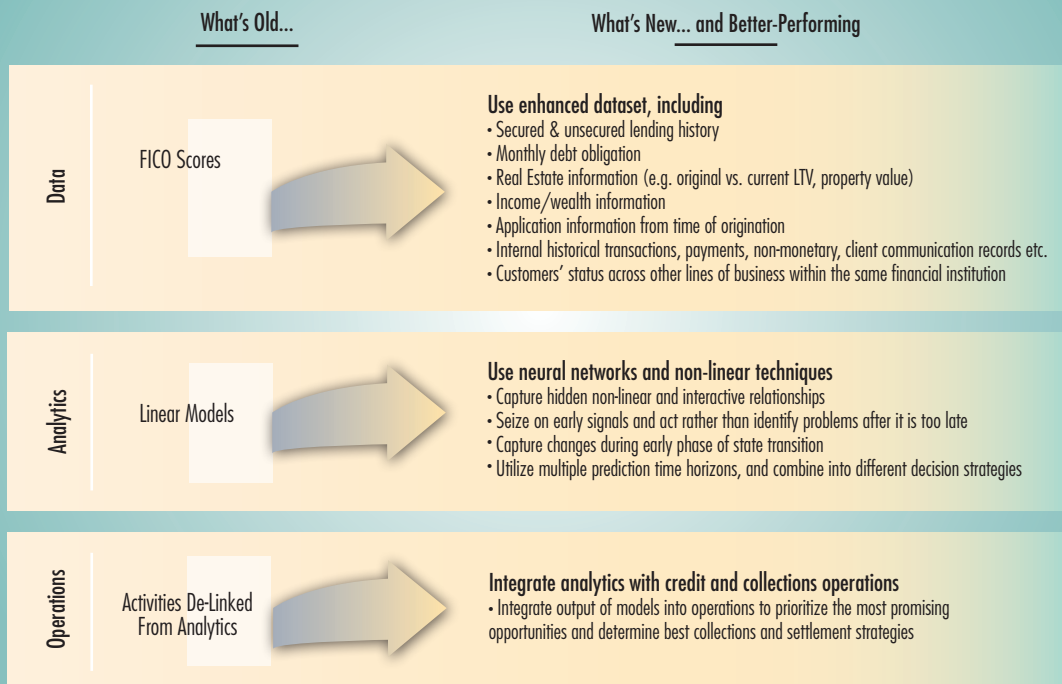
So while a file may show a red flag, it's critical to be able to identify good customers who will pull back from the brink without draconian measures and to understand which type of intervention will ensure the best outcome.

The key here is to *watch*—transaction by transaction, activity by activity—and look for early changes in behavior that can lead to problems, such as an increase in cash transactions, a change in payment patterns (later in the cycle, late altogether, minimum-dues), or a dramatic increase in credit utilization rates. We also look for signs of change such as an increase in the overall balance-to-debt level, a decrease in the overall payment level, delinquency in other credit lines even if the borrower is current for this line, a higher required mortgage payment (for example, an ARM reset) that leads to a significantly higher debt-to-income ratio, a loan-to-value ratio larger than 100 accompanied by a large mortgage payment increase, and other possible combinations of these factors.

In only a small percentage of cases do we find it necessary

Figure 2

Enhanced Risk Practices Improves Outcomes



to shut down the account. Alternatives can range from changing or reducing the line of credit to placing a shadow line in place to follow the account more closely. If a customer has been of long duration and high value, it sometimes makes sense simply to accept a higher degree of risk.

3 Recoverable—“Recoverables” are responsible borrowers who have defaulted, but who would repay if they could and will repay when they can.

The delinquency of these customers can be linked to specific trigger events, such as suddenly becoming unemployed. Because of the economic recession, this group is larger than ever before, right now representing 20–25% of defaulted loans. Applying standard dunning techniques to these people will garner only pennies on the dollar and potentially lose you far more important things: their goodwill now and their business when they recover (as they are almost 100% certain to do).

A smarter approach uses thoughtful, customized programs that nurture good customers gone bad back to financial health. We have found that handling recoverables with sensitivity and care delivers more than two and a half times the money that heavy-handed approaches do. Banks also earn the loyalty of customers who appreciate lenders who stand by them in difficult times. Plus, returning good customers to the economy brings significant benefits to everyone.

In general, recoverables exhibit behaviors that suggest they recognize a change in their circumstances and are trying to manage through it. In such cases, we see significant reductions in spending categories like entertainment, clothing purchases, dining out, and leisure travel. These are often the people who proactively attempt to protect their credit status by notifying their lenders of their situation and asking for a way to work through their debt.

For these customers—who potentially have very high long-term value—it is possible to develop a portfolio of solutions, programming them into the treatment options available to collection staff. This allows collectors to find the right option for each customer while optimizing returns for the lender.

4 Dry Holes—This group represents the 34% of customers who wind up defaulting and will never pay anything.

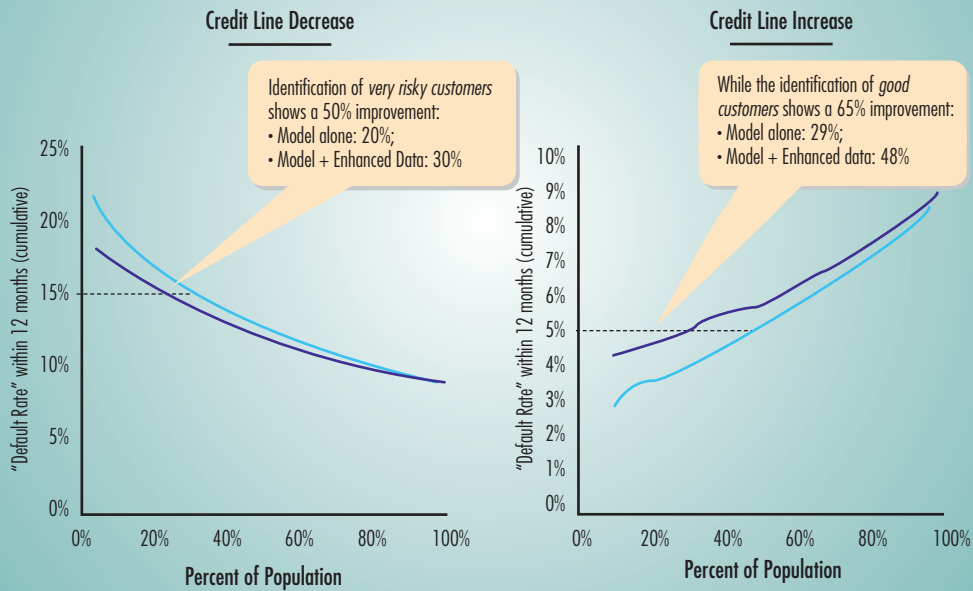
Don't take up scarce internal-collection resources by drilling dry holes. Their cases need to be closed quickly and their files moved to external agencies. Doing so can free up 10% or more of a bank's collection capacity, allowing resources to focus on accounts with higher payback potential.

Within this group are two categories of borrower, and they behave very differently. The first have good intentions of repaying, but when they get into trouble, they decide to use up all their available credit before going into default. What we see in their transaction behavior is a significant

Figure 3

A New Behavioral Model

By creating and applying additional data overlays to existing models we were able to significantly improve existing customers' risk assessment.



increase in indulgent spending—weekends in Las Vegas, purchases of high-end electronics, and so on. Spotting these changes in spending patterns early is the key to managing losses from these customers.

The other borrowers in this category are just plain “bust-outs.” They plan from the beginning to obtain as much credit as possible and just take off with it. To build lender confidence and increase their credit lines, they behave at first like responsible borrowers and pay on time. Frequently, the tip-off is that we see the same transactions over and over, such as small cash advances or balance shifting. A defaulted borrower with these patterns is unlikely to respond to collection requests and does not represent a relationship worth protecting. Rather than spend costly internal resources on these defaulters, lenders are better off moving their files directly to external agencies.

5 Just Need a Nudge—20% of defaults will cure with minimal intervention.

Don't use expensive channels like a personal collection call when a letter or text message will be just as effective.

These borrowers may have a history of late payments, but they have paid off their fees and brought their accounts current again. Third-party data may also show a relatively strong asset position (as opposed to one that is completely

underwater). These borrowers tend to respond to a collector's inquiries and want to pay off their bills. But remember that “less is more.” Keep the tone respectful and don't overspend on collections from this group.

Conclusion

Knowing which type of borrower you are dealing with can point you to detailed contact and collection strategies that improve recoveries, foster loyalty, and support higher profits in the long term. The key is to identify a general segment into which each individual fits and adopt a specific collection strategy that will maximize the long-term outcome.

In a sea of defaulting credit card customers and a fast-changing, complex economic environment, that's not such a simple task. Three things can help:

Using more sensitive and flexible segmentation models incorporating nonlinear and multivariate techniques.

Incorporating very recent behavioral data along with the pattern of customers' relationships over the long term.

Employing good old-fashioned business judgment. ❖



Arnab Gupta is chief executive officer and **Phillip Riese** is senior advisor at Opera Solutions, a global management-consulting firm. Contact them at agupta@operasolutions.com and prise@operasolutions.com.