Comprehensive Management of Profitability and Credit Risk

Making the shift from Product-Centric to Customer-Centric Management across the Credit Life Cycle

Vision and Strategy Document

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Overview

Bridgeforce is focused upon helping clients manage consumer and small business credit products, both in the US and internationally. Within this focus we work closely with clients across the full range of credit segments, often with multi-product customer relationships, and we see first-hand the importance of a comprehensive approach to managing risk and profitability.

We have found that for any strategy regarding the management of risk and profitability to be truly comprehensive, it must be comprehensive in two dimensions:

- Across products to take a full customer view
- Throughout the credit life cycle

Recent challenges in credit markets have highlighted the need for careful focus upon these topics, as any lack of alignment across either of those dimensions leads to reduced profitability. The rest of this document explores these concepts and their application throughout the cycle of customer relationships.

Across Products

Lenders have known for a long time that there are advantages to managing consumer credit relationships at the customer level instead of the account level, since more comprehensive information enables better decisions. As banks grew product-focused business lines became centralized, however, customer actions were more likely to be driven at a product level.

Sales and marketing are often the first areas to act upon the potential value of a customer-level view, and as a result many lenders have pursued strategies of creating deeper, stronger relationships with customers.

This can be a very good thing. It also, however, carries two dangers.

The first is well known and obvious: if a customer's financial condition worsens, the lender has more exposure than before associated with a single person.

The second is less obvious but also very important: loyal customers with multiple relationships often fall behind with other bills before they fall behind with their primary institution, **leaving that institution as the last to know there is a problem**.

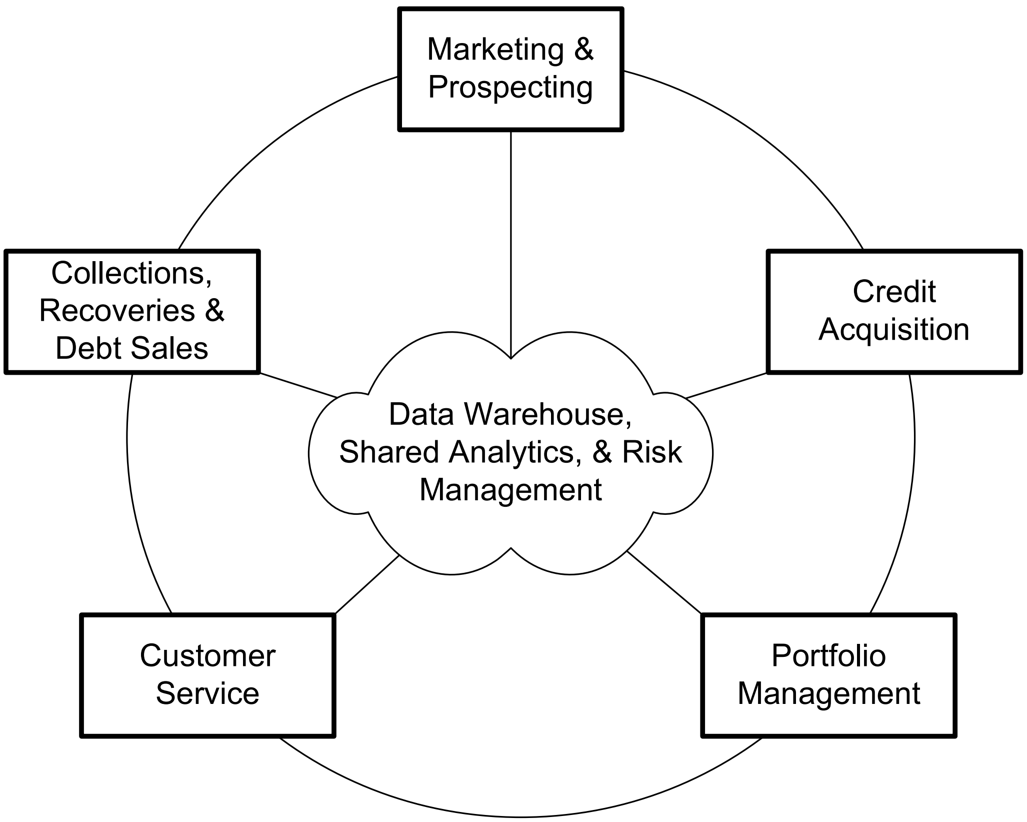
These two factors increase the importance of early detection in risk management and targeted customer-level treatment, which in turn are made much stronger by considering customer-level data.

Throughout the Credit Life Cycle

It is possible to profitably serve customers' needs in essentially any credit segment, but it is absolutely critical that the business practices throughout the credit life cycle are aligned with that segment. We have, for example, worked with clients who operate profitably in credit segments ranging from sub-500 to 750+ FICO scores. Profitability evaporates quickly in any segment, however, if the whole cycle is not in alignment.

Such alignment will require a greater level of communication, analytics, and coordination across business units that have previously been more independent than they would be in the new environment. Although the result of this coordination is ideal for the overall success of the company, overcoming the organizational momentum will require strong involvement at the Executive level.

The Credit Life Cycle



We view all of the steps above as a cycle, as the actions of each area impacts the results of the other areas. These impacts should the measured at a granular level and fed into the next decision loop. To be most effective, analysis and sharing of results must occur within a coordinated framework. This includes a common understanding of data sources and definitions, coordinated experimental design, and communication of detail sufficient to be actionable.

The rest of this document provides examples of the transformations that we see occurring in various functional areas of a financial institution as a result of the shift to a customer-centric focus and more coordinated action across the credit life cycle. The lists are by no means exhaustive, but hopefully help to provide the reader with a more concrete sense of the impact of these concepts upon operations.

Marketing & Prospecting

Current Process

1. Get a list of names from somewhere, whether internal, cross-sells from another division, partners, purchased lists, etc.
2. Scrub that list for bad addresses, duplicates, etc. (normal list cleansing).
3. Run the list against marketing criteria (typically credit characteristics) and response models for that particular product to segment leads into deciles based upon expected net response rates (response adjusted for expected approval rate for a loan product).
4. Decide upon how many deciles of the list to use for the promotion based upon the projected cost/benefit.
5. Execute the campaign.

Future Process

1. Get a list of names from somewhere, whether internal, cross-sells from another division, partners, purchased lists, etc.
2. Scrub that list for bad addresses, duplicates, etc. (normal list cleansing).
3. Run list against marketing criteria (typically credit characteristics, may include existing customer characteristics) for multiple products to segment leads into deciles based upon expected net response rates (response adjusted for expected approval rate for a loan product) for each product.
4. For each prospective customer, record the product in which their predicted response is in the highest decile (e.g. 3rd decile for Home Equity vs. 7th decile for credit card).
5. Using a combination of predictions of relative response and the financial value of a new customer for a particular product (e.g. the 3-yr NPV of a home equity relationship vs. a car loan vs. a credit card), create lists to market the combination of customers and products projected to be most profitable to the financial institution.
6. Depending upon results, you may market to a customer multiple times, but in planned order.
7. Test interactivity of marketing efforts (e.g. what is the impact on response to Home Equity offers of being solicited for a credit card simultaneously vs. sequentially?).

Note: All of the analysis in these steps must be performed at a granular segment level (averages hide far too much) re-evaluated based upon the granular analysis of previous campaigns (fraud, usage, attrition, delinquency and loss, etc.).

Required Changes:

- People: Incentives need to be broadened so that it is in people's best interest to market what is best for the bank, not one product line. This is true for marketing managers, branch tellers, and anyone else that affects what products are promoted to customers. Educate personnel regarding the new process and reasons behind it, which can be largely summed up to be thinking of each person's job in a broader context.

- Process: 1. Need to define method for rank-ordering across products, most likely based upon a combination of financial projections and strategic goals; 2. Information sharing across areas of the credit life cycle must be done at a granular level (campaign, risk segments within campaigns).

- Technology: 1. Normalize product value calculations (e.g. 3-yr NPV) so that all use the same basis and are therefore comparable; 2. Change list processing to efficiently enable checks across multiple products and the recording of decile rankings (or any similar rating system) at the customer level; 3. Create process to then generate product-specific lists for execution of campaigns; 4. Set up tests to better understand interactivity for the financial institution's customer base; 5. Find ways to adjust incentive systems to reflect broader priorities.

Credit Acquisition

Current Process

1. Receive application from prospective customer for a loan product.
2. Pull a credit bureau.
3. Make the decision based upon credit score and application information, with deference for existing customers in broad categories (wealth management, high deposit, etc.) and consideration of existing total exposure within product line.
4. The prospective customer is approved or declined for the requested product.

Future Process

1. Receive application from customer for a loan product.
2. Pull a credit bureau.
3. Make the decision based upon credit score, application information, and individualized existing customer information. This information is most powerful for holders of DDA accounts and credit cards, since transaction information can be much more informative than simply balance and payment information on a loan product.
4. If the customer is approved, evaluate for immediate up-sell or cross-sell options based upon customer characteristics and relative profitability of products (e.g.: Applicant for mortgage has relatively low balance in checking account but significant direct deposit activity that is them transferred to an account at another financial institution. Along with approving the mortgage, offer special incentives to simultaneously open investment account). This would leverage the tools described in the marketing section for prioritizing solicitations.
5. If the customer is declined, evaluate for immediate down-sell options based upon customer characteristics and relative profitability of products.

Notes: 1. Credit processes can enjoy much greater flexibility and accuracy with the addition of some human judgmental lending, but that may be beyond the scope of anything being considered.
2. Changes in credit criteria must first require projections to be reviewed and approved regarding expected changes in delinquency and loss, loss curve timing, selection bias, etc.
3. Those projections should be reviewed and adjusted as soon as response to a campaign matures, as shifts in selection bias or score migration can be detected immediately.

Required Changes:

- People: 1. Incentives should reflect bank priorities for up-sell, cross-sell, and down-sell. Most credit departments do not see themselves as cross-sell centers, but they can be very effective. 2. Educate personnel regarding selling techniques.
- Process: 1. Utilize method for rank-ordering across products developed for marketing; 2. Involve other areas of the credit life cycle to validate all assumptions regarding changes in credit criteria.
- Technology: 1. Access transactional data and incorporate knowledge into credit process for those customers; 2. Enable communication between credit and marketing to make cross-sells possible.

Portfolio Management

Current Process

1. Periodically analyze customer information to assess risks or needs relative to existing product (e.g. line increase, line decrease, re-pricing, etc.). Information is generally from account information and credit score or a limited number of credit bureau attributes.
2. Determine appropriate actions based upon profitability of single product.
3. Execute actions.

Future Process

1. Periodically analyze customer information to assess risks or needs relative to the entire financial institution product line. Information would include information from multiple accounts, potentially more detailed bureau attributes, and potentially other sources of data. Additional breadth of information will affect decisions in many ways, including cross-sells, credit line changes, authorizations (for card products), pre-collections, and fraud prevention.
2. Consider expanded potential liability (multiple credit lines, insurance, etc.) and assets as part of broader risk decision.
3. Consider future revenue potential as part of evaluation and expected impact of current decision upon future revenue. Extensive testing will be needed to optimize this. This is often done anecdotally today (e.g. low-fee student checking accounts offered in hopes of future customers), but can be improved in a customer-centric model (e.g. waive certain types of fees that aid in customer loyalty for customers with a highly profitable relationship).
4. Consider time-dependent inter-product relationships (e.g. Offer home equity line to mortgage customers 1-2 years after their mortgage was issued).

Required Changes:

- People: Continuing the theme: expand incentive system and goals to reflect bank-wide priorities; Educate analytics people, risk managers, etc., regarding the new process and reasons behind it.
- Process: View fees and revenues from actions taken on a specific account in the context of the affect on the overall relationship.
- Technology: Integrate information from all accounts with bureau data to more accurately assess customer risk and needs.

Customer Service

Current Process

1. Address customers either uniformly or segment based upon product line (wealth management, credit card, retail banking, etc.).
2. Perhaps segment service levels based upon profitability of customer for each product. Separate customer service operations for each major product line.
3. Customer service representatives do not address any issues related to credit risk
   - If a customer tells one of your representatives that he or she is unsure how to pay next month's bills, or foresees some form of financial hardship, what does your representative do?
   - In many organizations, the representative ends up saying "There is nothing I can do for you, but call us back after you are delinquent".

Future Process

1. Evaluate customers and segment service levels based upon profitability of total relationship.
2. Deliver multiple customer service levels based upon profitability of total relationship.
3. Cross-sell and up-sell customers based upon criteria described in previous sections.
4. Customer service representatives refer at-risk customers to an appropriate area to assess the financial situation and potentially take actions.

Required Changes:

- People: 1. Educate customer service personnel on cross-sell; 2. Modify personal incentives and division goals to reflect cross-sell and referral priorities.

- Process: 1. Adjust expectations for length of calls due to cross sells; 2. Institute measurements of additional costs vs. profitability of expanded relationships; 3. Monitor the quality of at-risk referrals.

- Technology: 1. Enable customer service personnel to have up-to-date product information regarding common cross-sells; 2. Develop methods for servicing multiple-relationship customers that are identified as high-value. This could range from the integration of customer service systems (long term, expensive, and big potential benefit) to high-priority warm-transfer queues to handle the needs of particularly profitable customers needing service from multiple centers. 3. There would be a substantial amount of analytics involved in optimizing the segmentation and cost/benefit of differentiated customer service and aggressive cross-selling.

Collections

Current Process

1. Assess risk and prioritize collections efforts based upon the size of the loan, bureau information, and custom internal scores.
2. Most organizations collect in an account-centric environment and segment risk almost exclusively based upon the number of months past due.
    - A customer with one credit card that is 30-day, one that is 120-day, and a car loan that is 30-day will be contacted through three independent collections processes.
    - Risk segmentation is at most used for making decisions regarding collections entry. Two customers that are both 20 days late are likely treated the same regardless of the rest of their risk profile.
3. Some products may collect at the product-centric level, so that the customer described above would be collected in two processes instead of three.

Future Process

1. Consider expanded potential liability (multiple credit lines, insurance, etc.) and assets as part of broader risk decision.
2. Leverage information from multiple accounts, particularly DDA transactional data where available, for early detection strategies (pre-collections). Account-centric risk scores have less significance than in the current state. Early identification enables much higher collection rates for high-risk customers.
3. Leverage cross-sells and consolidations where possible to exchange risky assets for less risky ones (e.g. home equity lines to consolidate credit card debt).
4. Assign all accounts for a particular customer based upon the most risky asset (also adjusted for the value of the different products). In our example above, all accounts would go to the 120-day card collector. Strategies and work processes would then be driven from that level of risk for all accounts. In this example, the 30-day card account would receive treatment like a 120-day account. This may involve sending the account to a skip-trace vendor, offering aggressive settlements, etc., that would not normally happen to a 30-day account.
5. Assign accounts to processes based upon risk attributes beyond days delinquent.

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Note: Consolidation of debts across stages of delinquency and product types can have regulatory and financial reporting impacts related to reserves for loss.

Required Changes:

- People: 1. Enable collectors to earn incentive from actions on multiple products based upon the risk of the customer (in our example above, treat the 30-day card account like the 120-day account for incentive purposes) 2. Educate collectors on new processes and options.

- Process: 1. Adjust expectations of work load and collection rates based upon customer risk and blend of accounts; 2. Change workload assignment criteria.

- Technology: 1. Enable account assignment and treatment based upon customer instead of stage of account. 2. Integrate information from all accounts with bureau data to more accurately assess customer risk both before and after entering collections.

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Summary

Managing credit relationships that are based upon all available customer information and consistent throughout the credit life cycle greatly increases profitability and reduces surprises. It also requires a greater investment of management focus, analytical skills, and technology.

The first step before moving to a more integrated approach, therefore, is recognition of the size of the opportunity. This can be done fairly quickly by examining your current processes and portfolio data. With that analysis and discussions among Executive Management, we can help you to develop your vision for the future, the roadmap to get there, and the business case to support the investment. Then the best part begins: making it happen, measuring the results, and continuing the cycle of success.

To learn more about how you can leverage any or all of the elements described in this document to enhance your organization's profitability, please give us a call to schedule an initial consultation.

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