White Paper

Credit Risk Triage in the COVID-19 Crisis

Cross-Organizational Best Practices for Winning in This New Era

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No amount of comprehensive risk and stress planning could have prepared lenders for the consummate economic ruination that has accompanied the arrival of the COVID-19 virus in early 2020. In the last three weeks of March, more unemployment claims (sixteen million) were filed in the US than in the entirety of the financial crisis of 2007-2008. (See Exhibit #1) Large areas of the economy have not merely faltered – they have completely shut down. In the face of this unprecedented freefall, what can lenders do to better manage credit risk? There are no guaranteed strategies for success, but this paper advocates several strategies which can mitigate the worst damage.

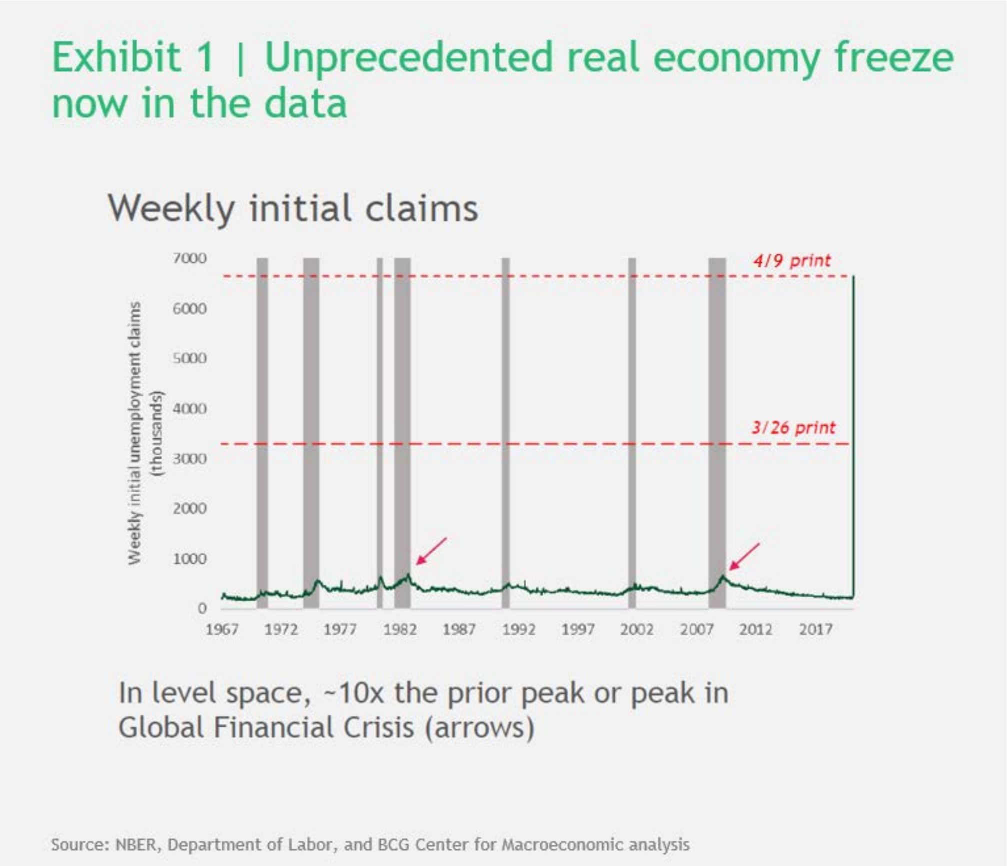


Exhibit 1 | Unprecedented real economy freeze now in the data

There are three chief ways in which lenders can make a difference. Firstly, they can introduce modifications to acquisitions strategy. Secondly, customer management policies can be examined and alterations introduced that can both alleviate risk and ensure that lenders can still properly service their existing customers. Finally, anti-fraud policies and tactics can and must be beefed up despite the restraint of capacity imposed by working from home orders.

[Note that this white paper does not cover collections. 2OS & BCG have already produced a companion paper outlining how to win in collections in this challenging environment; please see the footnotes for the link if you are interested in our perspective on collections.[1]]

ACQUISITIONS

Having built dozens of custom risk and valuation models for lenders, we have always firmly advocated the use of the most comprehensive data, the most advanced modeling techniques, and acquisition credit policies that cut out specific populations for complex de-averaging. But given the extremely rapid changes to the environment and borrower behavior, faith cannot be placed in these models in this crisis.

COVID-19 has utterly changed the market dynamic. It is not enough to simply adjust credit standards; old standards and tactics designed to reduce loss using benign period data are simply not valid in these changed circumstances. The most realistic lenders are ditching all existing acquisition policies and proceeding from the a priori assumption that they will make no new loans. This "zero-based lending" approach may seem draconian; under its terms new loans may be added only if the lender is absolutely convinced that the loan's risk will hold up under these new, uniquely stressed conditions. In such conditions, some customers that in the past have enjoyed good or excellent credit will become highly risky – and existing credit methodologies will be **very** poor at spotting this newly delinquent class.

This zero-based lending strategy is doubtless alarming to some lenders – and it is undoubtedly dramatically different to normal operating procedure – but it is an indispensable principle that forces an organization to radically restructure acquisitions policy according to the demands of the COVID-19 crisis. There is an important point to be made here about use of staff as well. The zero-based lending strategy will free up a lender's underwriters and loan managers, and these can be usefully reassigned to manual verification departments to counter the inevitable rise in fraud & delinquencies.

[1] https://www.linkedin.com/feed/update/urn:li:activity:6648178500404596736/

An example of this sort of drastic change would be to modify models such that no new loans can be approved unless the customer is predicted to be profit-neutral or better with two and a half times losses as predicted by the current risk model. While this number will not necessarily suit all lenders, using an elevated risk scalar is an important benchmark that can be scrutinized internally by the analytics team. Creating these kinds of new overlays is an important step for any lender in the COVID-19 downturn.

Loans that require stringent income verification before approval need to be modified to make sure customers in vulnerable employment situations are identified. For example, a customer working in the hospitality industry might have supplied pay-stubs that are both recent and impressive, yet that job may no longer exist and the loan should now be categorized as high risk. In such cases, additional layers of verification should be added, such as calls to the employer to confirm employment status. Borrower-forward signals are also much more important signposts than they would be in a more benign period. A customer suffering severe financial distress as a result of COVID-19 dislocation is likely to be far less willing to accept a down payment on a point-of-sale loan, while customers that are willing to make a down payment on a loan need to be recognized and noted by lenders. Significantly reappraised acquisitions policies and significantly more stringent income verifications standards will help banks avoid bad loans but also help better manage existing customers.

Adroit lenders are also turning to performance data drawn from previous US natural disasters as a guide in the midst of COVID-19. Credit applications rose between two and five times in earlier catastrophes. Studies might include:

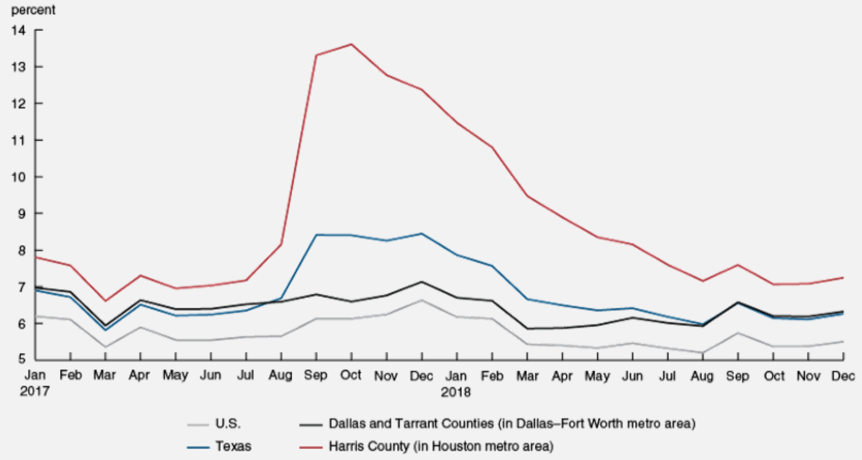
- Performance of all asset classes in coastal Louisiana during and after Hurricane Katrina.
- Performance of flooded businesses in Houston during and after 2017's Hurricane Harvey. (See Exhibit #2 for data from the Chicago Fed[2] on this topic.)
- Performance of asset classes in Puerto Rico during and after 2017's Hurricane Maria.

There are caveats to the usefulness of this information: it will, for example, likely take five or six weeks to accumulate archives featuring off-lender data at any of the three major bureaus.

2 https://www.chicagofed.org/publications/chicago-fed-letter/2019/415

Nonetheless, possession of data grounded in verified facts about lending in crisis will give sensible lenders an edge over rivals. These institutions can form significantly clearer hypotheses of how customers will behave during the downturn, and how they may recover. Use of internal and external risk experts will aid the process of understanding the data.

Exhibit 2 | Chicago Fed data on mortgage delinquency in the aftermath of 2017's Hurricane Harvey



Source: Chicago Fed's study on the impact of Hurricane Harvey

Lenders making good use of data may also pivot from zero-based lending, described above, to so-called "small sample-based lending" in which they accept only around 5% of applications that would have been accepted under normal conditions. This segment of customers can be used as a sample group, providing first-hand information to the lender about the severity of conditions and allowing it to achieve better positioning for the recovery.

So far, different asset classes and product lines have responded differently to the unique circumstances of COVID-19. The most acutely affected have been small business loan and card programs. In many cases, firms have completely closed down lending or drastically curtailed it – with the exception of loans under the auspices of government-backed programs such as CARES Act PPP loans.

CUSTOMER MANAGEMENT

Navigating account management is even trickier than customer acquisitions. Failure to extend new loans is relatively easy to justify and carries few reputational consequences, but this not the case when a lender seeks to restrict risk by changing the terms of accounts of existing customers. Nonetheless, some risk mitigation steps will have to be taken.

Card issuers have more tools at their disposal to evaluate. These issuers should, for example, close down credit line increase (CLI) facilities or make them much more restrictive. These facilities represent much increased risk exposure for banks and, as noted, the models built in a pre-COVID-19 world are no longer fit for purpose. Wise banks are already taking the stance that CLIs can be justified only if extremely compelling evidence in favor is presented and the customer in question has a strong existing relationship.

Conversely, and perhaps counter-intuitively, credit line decrease (CLD) programs are not a panacea. Many banks turn to CLD programs in the event of economic stress, but we urge caution in placing much greater reliance on these programs in this particular downturn. CLD programs not only represent significant reputational risk; they may also increase credit risk rather than diminish it. This is because notice of the CLD itself to the customer serves as a reminder that the card exists, which in turn might encourage the by now-aggrieved customer to run up larger amounts of debt than would otherwise have been the case. This feeling of resentment can also make the customer place this card lower in the list of bills to be paid, which can become a significant consequence to the lender when many customers are struggling to meet obligations. Due to the increased financial risk and greater reputational risk, large-scale CLDs should be used only as a last resort. They have their place in a limited form, but excessive use during a downturn exposes a bank to more risk than they realize.

A much better strategy is to have significantly more aggressive inactive termination policies. Research shows that customers who reactivate their cards in a recession after a long dormant period carry significantly higher inherent risk than those who reactivate in a benign scenario. This was especially true in the 2007 financial crisis, and we foresee similar behavior during this downturn. In anticipation of this, one card issuer has already changed its definition of an inactive account from one which has had 12-18 months without new purchases or balances to only four months. Avoiding customers who reactivate accounts is an important goal for COVID-19 risk management. It is also is relatively easy to explain from a credit risk point of view, and thus carries less reputational risk. Suspension of credit for delinquent customers often becomes more draconian in a crisis, and some lenders have already cut back the point at which credit is suspended from 30-60 days past due (DPD) to as little as five to ten days DPD.

Balance transfer programs should also be shut down or restricted significantly for the duration of this crisis. Like CLIs, they can expose the bank to more debt with a higher than average risk of a charge-off. Balance transfers, if unchecked, carry moral hazard as well as during the last recession distressed customers used the technique to expand their access to credit.

The management of relationships with partners will involve difficult and painful decision-making, particularly if those partners run travel or retail businesses. These are exposed to the fiercest gales of this crisis, and many have already furloughed staff and/or made large-scale redundancies. Banks can't wait to see if these businesses bounce back whenever the lockdown ends.

On the other hand, smart banks are also developing more sophisticated autopay policies. Customers should be strongly incentivized to sign up for automatic payment and direct debit accounts. Personal loan lenders know that getting borrowers on autopay is worth much more in a crisis than in benign times, and this is especially true for those customers that have already entered collections.

Beyond shifting policies, banks can also make the most possible use of data gathering to provide the earliest possible evidence of a customer's financial well-being. Functions that assess card transaction patterns and overall transaction velocity might be leveraged, for example. Banks could be alerted if a card is being persistently used in an area of high infection, while deposit account activity could be scrutinized for clues about a customer's financial health and the likelihood that they are still in employment. Differences between salaried and hourly workers could also be gleaned from this kind of investigation into checking account transactions.

Data could also be used to detect positive financial changes, such as customers receiving larger paychecks due to overtime or customers who were unemployed returning to work. There are many options out there; it's up to analytics teams to figure out the available data and then how to analyze it for the maximum value to the bank

FRAUD CONTROL

As every lender will attest, fraudulent activity has gone up a great deal since the start of the COVID-19 crisis. This is principally due to increased opportunity; manual detection capacity at lenders has slumped by anywhere from 5% to 30%.

The biggest risk for banks is increased application fraud. Criminals have tens of millions of stolen and synthetic identities and are looking for opportunities as normal fraud defenses are weakened by the chaos of the crisis. Banks need to beef up fraud detection teams by redeploying workers that are now under-employed. They must also tighten up and increase the normal fraud triggers– a lender who does not crack down on fraud while its competitors do so will find itself attracting a disproportionate number of attacks.

Transaction fraud also increased in the last downturn, so it's crucial that banks react quickly and raise thresholds here too. While this will mean some good transactions are declined, it will also mean the incidence of transaction fraud will not increase quite as much, which will help mitigate overall fraud losses. Some examples of transactions that should raise additional flags include: transactions conducted outside the customer's zip code, transactions with significantly higher than expected value, and transactions that occur at a higher velocity than the customer normally operates at.

In concert with this, lenders are also using two-way SMS transaction verification. They are shoring up vulnerabilities in "card not present" authorization rules as well by declining all CVV mismatches for the duration of the crisis, in an effort to ensure that fraudsters can't enact transactions without 100% of the necessary information. Credit governance exception processes can be used to get quick approval for these threshold changes.

CONCLUSION

The COVID-19 crisis is unquestionably a terrible humanitarian crisis. But it also represents an unprecedented financial crisis, and one that is uniquely broad in scope. Every lender in the US is bracing for exceedingly difficult conditions over the next several months, and perhaps even longer. Delinquencies are expected to explode, and hardship management at virtually every bank is going to be pushed to breaking point.

We have isolated many recommendations in this white paper; these can be summarized in a discrete six-point COVID-19 plan.

- IMPOSE ZERO-BASED LENDING: all additional exposure must pass *significantly* more onerous checks before approval. Without a great deal of utterly convincing supporting evidence, make zero new loans, balance transfers, or line increases.
- REMEMBER THAT CLDS AREN'T A CURE-ALL: line decreases always run the risk of adverse selection, which, in this crisis, is much worse than normal. It is crucial to cut off as many reactivators as possible, even if this means a few more customers are left at a line that is too high.
- APPLY AGGRESSIVE INACTIVE TERMINATIONS: inactive terminations cut the tail for reactivator risk, making them one of the most effective weapons in a bank's arsenal.
- INCENTIVIZE AUTOPAY; banks need to try to get as many customers as possible to switch to autopay, especially focused on profitable benign-period revolvers. Autopay accounts help maintain a consistent cash flow, crucial for getting through this crisis.
- IMPROVED MONITORING TECHNIQUES: banks need to concentrate on data that provides a more recent picture of the borrower's financial status, tracking both negative and positive changes.
- MAKE FRAUD CAPTURE AGGRESSIVE: with fraudsters more active than before and decreased capacity in manual fraud review teams, it's crucial to make automatic fraud detection far more aggressive than it is in benign periods.

Unfortunately, none of these strategies are going to prevent all the damage that will be done. They are all, in essence, palliative. The best long-term route for banking survival is for the virus to subside. Despite this, those financial institutions that use this roadmap will exit this crisis in a significantly stronger place than those that don't.

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