White Paper

Unsecured debt deferral: the next set of challenges

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As the global banking industry navigates its way through the economic dislocation of COVID-19, short-term debt deferral (typically used for natural disasters) and loan extension have played key roles in supporting distressed borrowers and suppressing delinquencies. As a result, the volume of debt in forbearance has hit levels never seen before. For example, one lender had less than 10bps of its credit card portfolio in forbearance on March 1, by June 1 the number was close to 4%, - more than 50 times higher.

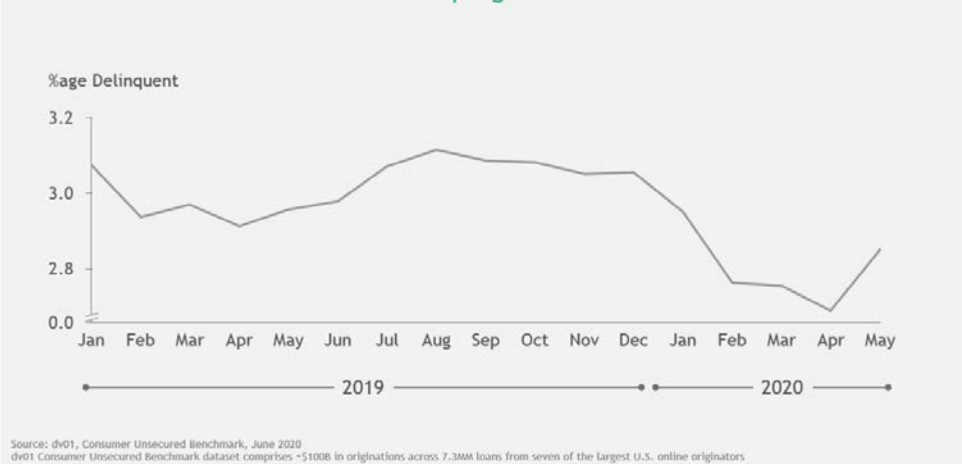
Forbearance increased sharply for most banks in late March and April, and lenders must now decide how best to handle the imminent expiry of that wave of deferrals. As of this writing in mid-June, the prevailing belief is that the best thing for borrower and lender is to extend deferral, in many cases by another 30-90 days. But the strategy and tactics of assessing comparative risk, deciding which borrowers receive additional extension and then communicating those decisions to borrowers vary widely.

As deferral terms expire, lenders must pay close attention to a few key issues:

- Industry trends and their peers' responses to deferrals
- How to assess underlying quality / performance of deferred loans; and
- Strategies to exit the deferral period successfully

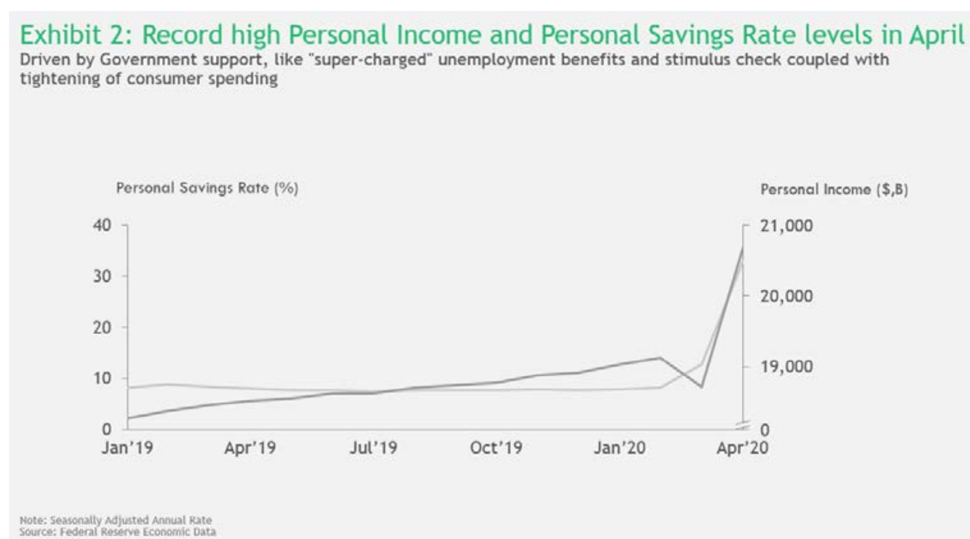
Industry trends

Government and bank intervention leading to falling delinquencies – most lenders are currently seeing what might be called the calm before the storm — despite widespread unemployment and financial distress, delinquency rates have fallen over the last few months.



This is due to several factors:

- Deferral and extension programs extended by banks.
- Super-charged unemployment benefits which have propped up many consumers despite job loss (refer exhibit 2).
- Other government initiatives e.g., Paycheck Protection Program (PPP) which have enabled employers to retain workers who would have otherwise been furloughed.
- Diminished household spending due to economic concerns and COVID-19-related stay-at-home orders leading to record high levels of savings (refer exhibit 2).



Bureau data has become much less reliable – the CARES Act declared COVID-19 a natural disaster, which allowed credit bureaus to apply a natural disaster code (NDC) to tradelines in customer reports. When credit bureaus employ an NDC, tradeline information drops out of borrower credit data entirely until the NDC is declared over. This trade information is also excluded from aggregated bureau variables, so any DQ information acquired prior to the COVID-19 crisis would not be tabulated as part of aggregate utilization or balance variables. This difficulty with the reliability of bureau data is compounded further by the fact that not all lenders have reported COVID-19 deferrals under an NDC.

This leads to a variety of consequences. If the excluded trade has had a positive history, then the customer's risk scores will likely deteriorate. But, if the excluded trade has had a negative history, then the customer's risk scores should improve, making him or her appear a lower risk than is in fact the case. The net result of this is that in the aftermath of COVID-19

risk scores will be to some degree muddled, and customers emerging from the NDC will show a credit score that shifts appreciably from month to month.

The manner in which deferrals and forbearance are reported to the credit bureaus also varies from lender to lender. Depending on the lender's effectiveness at communicating customer status to the bureau, some trades may not be properly flagged, which further confuses credit bureau data. If a lender does not adequately report an account status, trade lines in forbearance might be categorized as a current loan in a customer score, potentially inflating risk scores. While bureau data will still be valuable as COVID-19 winds down, it will be important for lenders to closely monitor the variable distribution of their models if they want credit decisions to perform according to expectations.

Increase in unsolicited payments and settlements – the number of customers making sudden, and often large payments in late-stage collections and even recovery stage has increased as a result of the unexpected government windfall. Some customers have more than usual disposable income at the moment through the combination of loan forbearance, reduced spending, super-charged unemployment benefits and government stimulus measures. Some lenders have consequently seen an improvement in post-default recovery income over the last two months, underpinned by settlement volumes and unsolicited paid-in-full payments.

Wide variation in approach to deferrals/extensions – starting in mid-March, almost all lenders took the approach of allowing customers some form of loan extension. Most lenders allowed either monthly extensions up to 90 days for unsecured loans or provided a single 90-day extension, while the majority planned further extensions after the initial 90 days. Leading lenders used a digital approach when enrolling customers in forbearance while others relied on more traditional channels. Digital channels offer advantages of scale, which helps when call center capacity is constrained, but traditional channels are more suitable when lenders want to ensure extensions go to those most directly and adversely affected by the consequences of the pandemic.

A variety of practice exists among large banks on whether to offer additional payment relief after 90 days. Most are planning to allow the customer another 60-90 days of relief, since

many consumers are being kept afloat by government stimulus measures and unemployment benefits that have a limited duration.

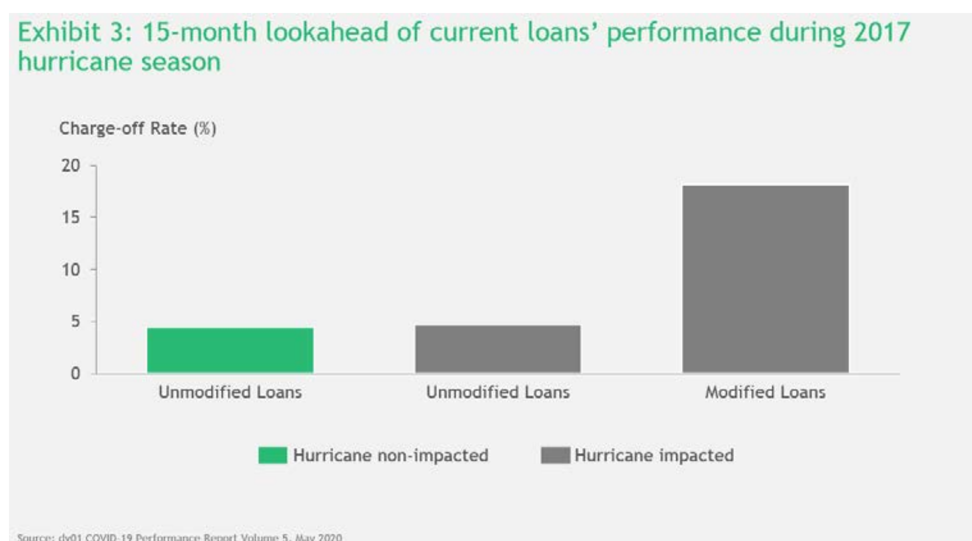
All of these factors combine to create the current paradoxical state of affairs, where, in the midst of the worst public health and unemployment crisis in our lifetimes, customer savings are rising, delinquency rates are falling, and collection call centers are overstaffed.

However, we feel that these circumstances mask the underlying portfolio risk. In addition, lack of reliable data is making it difficult for banks to make informed decisions as the second wave of deferrals gets closer.

Assessment of underlying performance

Post-extension risk levels – COVID-19 represents a once-in-a-lifetime moment in lending, or so we hope. There isn't much unambiguous historical data to help us understand the risk levels customers represent as they emerge from deferral and/or extension programs. The best template might be the experience of customers who were affected at a local level by a natural disaster, such as Hurricane Harvey in 2017.

According to analytics firm dv01, which examined lender securitization data, those customers which received hurricane deferrals were three to four times more risky than other current customers (refer exhibit 3).



In terms of the economic damage inflicted, those events were much less severe than COVID-19. For example, in the area impacted by Hurricane Harvey, the unemployment rate increased by ~200bps immediately after the storm, but it had come down again within a few months. There was nothing similar to the $600 per week unemployment subsidy we have seen in 2020 and the rate of deferrals was also much less. We would therefore suggest lenders use this data to establish a floor for possible loan performance when subsidies end.

ITIN versus SSN performance – Looking for other proxies, we focused on customers with only an Individual Taxpayer Identification Number (ITIN) and compared their risk levels to those with a Social Security Number (SSN). Since a customer must have an SSN to qualify for stimulus and/or unemployment benefits, this comparison represents a useful proxy for understanding the effect of government programs upon delinquency and underlying loan performance. We found that ITIN-only customers exhibited risk levels 30% higher (refer exhibit 4) when compared to customers with an SSN during the period of COVID-related government stimulus.

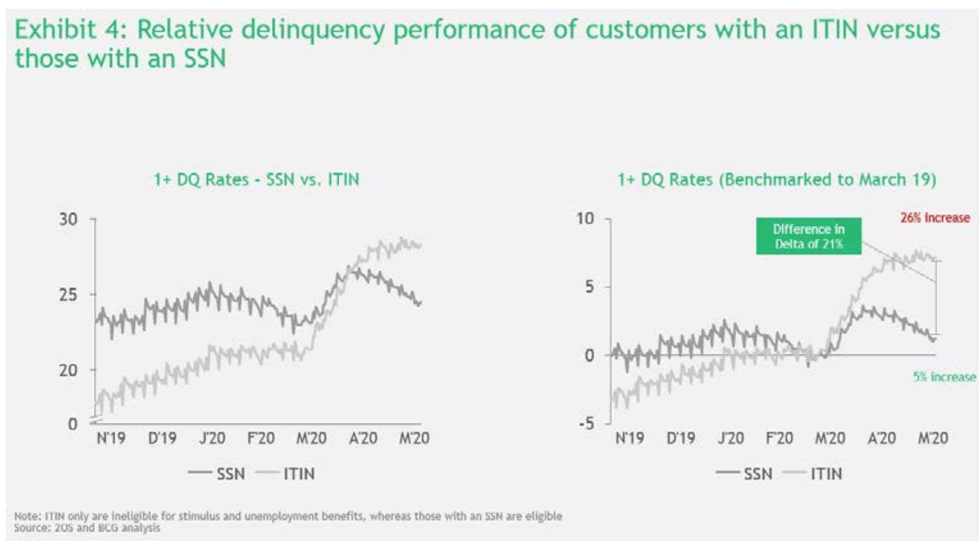
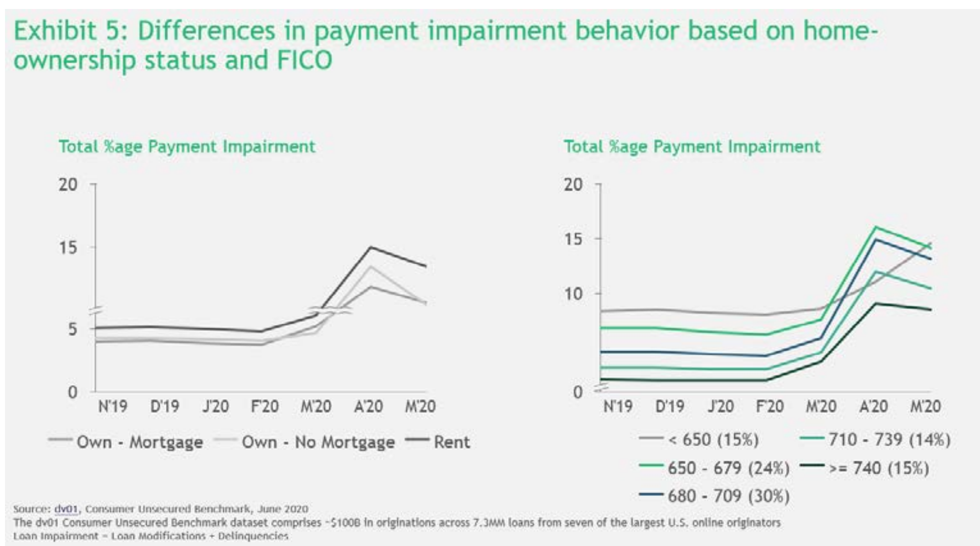


Exhibit 4: Relative delinquency performance of customers with an ITIN versus those with an SSN

Note: ITIN only are ineligible for stimulus and unemployment benefits, whereas those with an SSN are eligible
Source: 2OS and BCG analysis

Payment activity during deferral – while many deferred customers represent elevated levels of risk, some deferred customers have continued to make payments even when not required to do so. At some lenders, more than 50% of all deferred customers have made some kind of payment and over 20% of deferred customers have made all minimum or required payments. This segment represents much less risk than other deferred customers. Indeed, many lenders have difficult strategic choices on how to segment and treat "paying" vs. "non-paying" hardship customers.

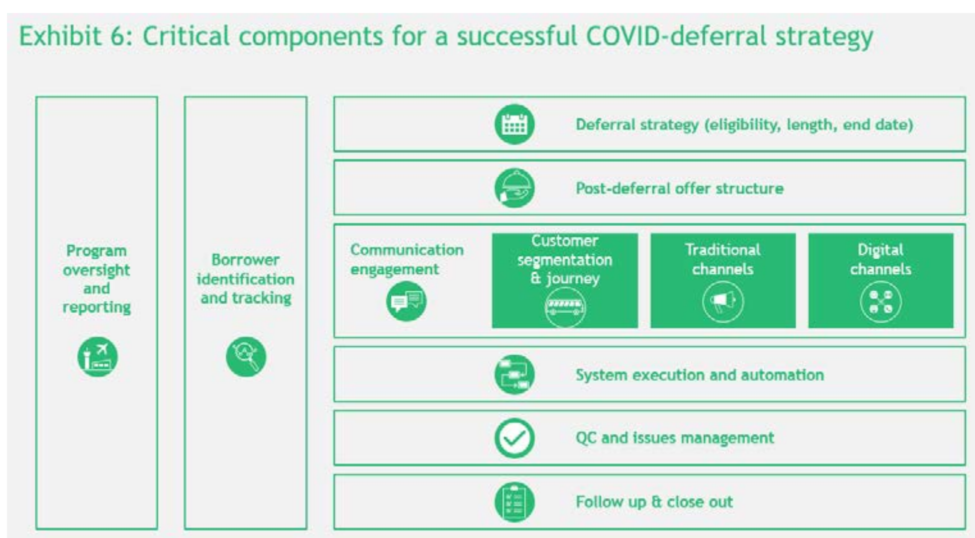
Post-deferral behavior – customers who have been in deferral for three months or more and then become delinquent will usually be riskier than their total days past due would normally suggest. Put another way, an ex-deferral customer is likely to be riskier at the same stage of delinquency than a never-deferred customer. The former will have higher roll rates and be more likely to default than typical bank collection models indicate. We encourage creditors to regard customers moving out of deferral as a separate portfolio of risk in terms of collections-stage segmentation, offer eligibility, and loss forecasting. As initial performance data in deferral becomes more available, we think it likely that repayment behavior will differ according to home-ownership status and FICO (refer exhibit 5).



Historically, home ownership status has been a critical risk determinant, and this has become even more pronounced during COVID-19. Home owners facing hardship are covered by the CARES Act but renters are not similarly covered and thus face a higher payment burden. Another contributing factor is desire of home owners to maintain a strong credit profile to take advantage of refinancing options at lower interest rates.

Best practices to manage the upcoming ‘forbearance cliff’

A holistic approach to managing the deferral program – lenders need to quickly build capabilities to manage the large number of expirations and renewal requests. In addition, banks need to prepare for a wide range of possible scenarios based on factors such as possible future stimulus and disease progression. Banks should bear in mind the key goals of the program and make sure capacities are in place that make those goals attainable (refer exhibit 6). They should also be ready to pivot their approach within weeks, not months, if conditions so dictate.



Data-driven renewal strategy to better understand risk – a one size fits all approach when renewing deferrals is not appropriate. We suggest using internal risk scores, past and recent collections/payment history and other behavioral indicators to differentiate projected risk. This risk-based approach to renewals can allow deferrals to be provided to those customers in greatest need and where it is most likely to be NPV positive. In addition, as credit bureau information is muddied by inconsistent forbearance reporting, we encourage lenders to carefully mine internal transaction data to determine likely customer financial health. For example, customers with both DDA and credit card account with the same bank can yield extra sources of useful information.

Hardship assistance focused on right customers – if banks have the call center capacity to manage it, a more detailed questionnaire and/or proof of job or income loss would help

ensure that the next round of deferrals goes to those most in need. The imminent deferrals should be used to bridge temporary disruptions to a customer's ability to pay and banks should ensure customers with different needs receive offers tailored to those needs

Offer suite for former deferral customers – Banks should pay particular attention to program design and the eligibility criteria for payment plans, skip pays and so forth, as well as settlement criteria in collections and recoveries. As pointed out earlier, customers moving out of deferral represent a much higher risk than their stage of delinquency suggests, meaning that eligibility criteria for payment plans and settlement should be reviewed quickly. Card issuers should review their re-age criteria to make sure that they are compliant with regulatory guidance but are not unnecessarily conservative. We have encountered a wide variety of re-age policies and practices; for example, automatic re-ages are allowed by some large banks but not others. Re-aging is a great way to provide relief to consumers whose deferrals have expired and have moved into delinquency.

Some institutions are considering new types of offers that allow customers to keep the lending relationship alive, or re-start that relationship after a payment plan has been completed. Many tried-and-true collections offers do not provide the customer the ability to regain charging privileges once the offer is completed. Banks should study the details of their offer suite and ensure they are not driving away good long-term customers who will recover quickly.

Timing of offers is also important. As noted earlier, post-deferral customers should be treated separately since many have greater than normal levels of short-term cash. We recommend lenders introduce payment plans and settlement programs earlier than is standard in the collection cycle. For example, one issuer we know is allowing post-deferral customers in bucket two of collections to be eligible for a reduced APR program and is also moving settlement eligibility from bucket 5 to bucket 3. Savvy lenders are building models to predict the best outcomes for these customers.

Borrower outreach and engagement, leading with digital – we would suggest that all lenders have frequent communications with customers in deferral. In this way they can build loyalty during the crisis, while also guiding customers towards making on-time payments again. For many borrowers, deferrals are a new experience and they may not

remember expiry dates, so it is important to make sure the next payment date is clear throughout. Communications should also stress to customers that they are accruing interest during the deferral. We recommend an integrated, omni-channel approach led by digital communication, in which a customized channel evolves as the customer gets closer to deferral and which will be structured according to what actions they take or don't take. This is the most cost efficient way to build re-engagement.

Accelerate execution – banks should increase capacity of the teams involved in execution of the defined outreach strategy for deferral customers. Traditionally, speed of execution has not been a high priority for a collections team. They tend to rely on handful of IT analysts to develop digital copies and it can often take several months to put the test into the field. Lenders finding it difficult to recruit and train the right people, should redeploy resources from other teams e.g., upstream credit teams to fill gap. Banks which rely on third parties should work with them to plan expansion of capacity as early as possible. Another critical aspect will be the ability to quickly adapt to the changing environment and change outreach plans accordingly.

Use communications and servicing strategies to drive repayments – as a data-driven approach to renewal decisions will be imperfect, wise lenders are using messaging and prompts so customers can themselves convey willingness and ability to return to making payments. A digital-first approach is cost and resource effective, but can also create opportunities for customers to opt out of deferrals should they desire. Successful examples used by clients include:

- Informing customers in deferral how much they can save by exiting deferral early.
- Making it easy for customers to start repaying through simple prompts and multi-channel payment methodologies.
- Conditional contact strategies where calling is initiated for highest value customers who have not responded to digital communication.
- Writing deferral communications in such a manner that presumes the customer will return to making normal payments.

CONCLUSION

We strongly believe that when government assistance programs end and banks stop offering deferrals, the current glut of deferrals will turn into a wave of delinquencies. The time for banks to act is now, and they need to quickly build a clear set of differentiated strategies and priorities for the deferral program. They need to examine closely the following points.

1. What is the objective function or mission for collections right now? To minimize credit losses or maximize the NPV of customer lifetime value? These are two very different objectives which will require different strategies.
2. How can the lender identify and retain as many valuable current customers as possible, knowing that long-term customer loyalty will be stimulated by the support banks offer during the pandemic?
3. How can banks find the right collections strategy and the most suitable offers for customers in severe long-term hardship to minimize the severity of charge-offs?
4. Banks need to manage this process exceptionally well during the crisis. Regulatory priorities of safety & soundness and consumer protection will receive heightened attention during and after the crisis. The tension and trade-offs between consumer protection and loss minimization are evident and should be managed closely.
5. The choices a bank makes should be well-documented from the outset. Banks will need to explain these decisions to regulators, investors and the public, so the rationale should be made clear and also examined for the likely reaction before implementation.

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Special thanks to dv01, a credit analytics firm whose analysis has been cited in several places in this whitepaper. Learn more about dv01's products at https://dv01.co.

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