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How Winning Lenders Enhance Analytics for Profitable Growth

Covid-19 Crisis Will Create Winners and Losers

The COVID-19 pandemic's financial impact on key sectors of the economy has triggered some tightening of business and consumer lending requirements, and banks have been imposing more stringent standards for borrowers, especially consumers. This change is borne out by the Fed's July 2020 Senior Loan Officer Opinion Survey on Bank Lending Practices. In addition, leading banks continue to increase reserve rates on consumer loan portfolios in anticipation of higher delinquencies to come.

While many traditional lenders have pulled back from consumer lending due to new uncertainties in their risk model and funding pressures, other competitors are pursing profitable growth. There is an opportunity in the consumer lending space to capitalize on market opportunities created by lenders' tightening of the traditional FICO-based credit box, as one executive puts it. Savvy banks can outpace the competition by maintaining marketing programs aimed at driving customer acquisition.

Executing on Profitable Growth

We've seen a trend where some leading national scale lenders have been able to originate loans during COVID-19 because of investments in enhanced analytics for risk, marketing and operations functions. This is a major competitive differentiator, as these enhanced capabilities enable lenders to drive profitable growth in all phases of the credit cycle. A former CEO of auto finance and credit card businesses shared that, in his experience, relentless execution of enhanced analytics delivered both higher returns on capital and profitable growth.

If you're a consumer lender, there are distinct ways to enhance your credit risk analytics capabilities. Just having better analytical models is insufficient to drive profitable growth. Three areas in combination need to be developed:

- Advanced credit risk analytics that score risk at the micro-segment or individual level
- Embedding advanced risk analytics into originations and collections processes
- Managing to ROI targets for profitability

Enhancing risk analytics

Consumer lenders want more "good" borrowers who may be late on a loan payment(s) and accrue interest and late fees but eventually return to current status. These are their most profitable customers. Lenders wish to avoid "bad" credits who roll through 30, 60, 90 and 120-day delinquency buckets and end up as charge-offs.

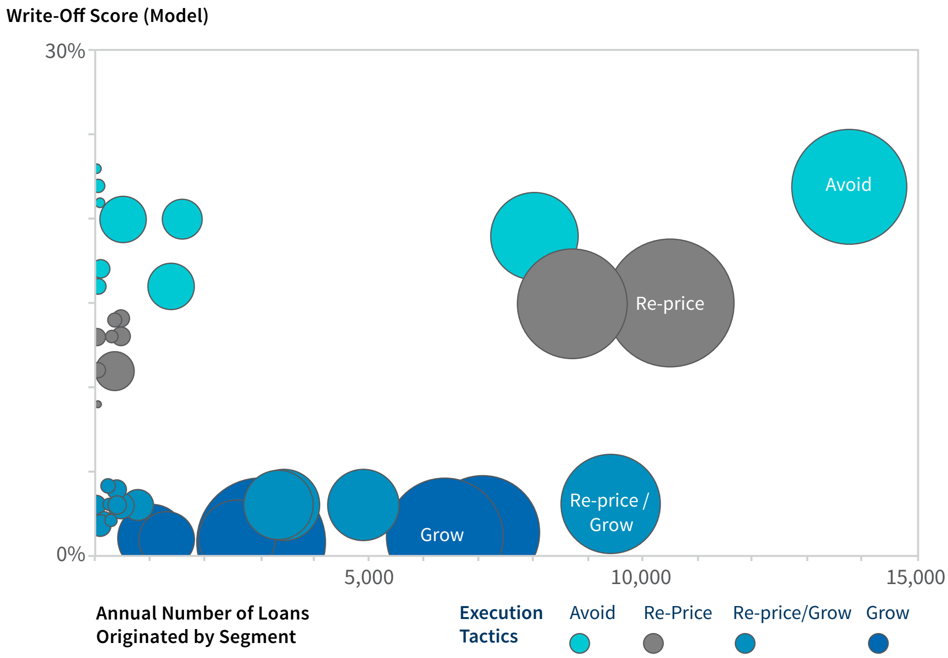
Enhanced risk analytics need to enable lenders to differentiate between good and bad risk customers within the same FICO band. While credit risk executives understand that a FICO score is imperfect in predicting risk, many still rely on it as a primary loan underwriting factor. In today's COVID-impacted economy, FICO is a less reliable indicator in distinguishing borrower risk. People with high FICO scores and strong employment histories might not represent good credit if they work in industries acutely impacted by COVID, such as travel, hospitality, retail and commercial real estate. Credit risk analytics must evolve to consider geography, employment industry and other unstructured data variables beyond the traditional ones. Leading purchase finance lenders now connect via API to Plaid, a platform acquired by VISA, to assess risk, with borrower's consent, based on individual purchase behavior. Plaid and other platforms enable API access to a borrower's bank account transaction data for modeling of weekly and monthly cash flow, and access to credit card accounts for analyzing purchase transaction data.

Enhanced risk analytics is critically important in financing purchases on mobile devices. Leading players like PayPal and Affirm have made significant investments to differentiate between "good" and "bad" credits and make credit offers in milliseconds. Lenders score each customer on default risk using multivariate machine learning algorithms that consider a consumer's credit risk based on financial situation, product purchases, and spending behavior. Financing purchases today goes beyond traditional eCommerce and are now embedded into the order workflow of vertically-focused mobile platforms in home improvement contracting, pool/spa contractors, dental, medicine and automobiles.

Exhibit I shows an example of the power of enhanced multivariate risk analytics. This purchase finance lender traditionally assigned a borrower with a FICO score between 620 and 650 into one of two risk segments and priced the loan using a static scorecard. Enhanced risk analytics stratified the same portfolio of 620-650 FICO borrowers into 45 segments. Modeling the write-off likelihood for each segment enabled the lender to take differentiated actions such as growing attractive segments, re-pricing for risk and avoiding high risk segments.

Exhibit 1 - Illustrative Client Risk Based Segmentation Analysis

FTI modelling of write-off scores for 45 segments within the portfolio of 620-650 FICO borrowers enabled the company to target micro-segments for growth, price based on risk and avoid high risk credits



- Bubble size represents contract value $
- Potential actions indicated are re-price, avoid, and grow
- Advanced risk analytics enabled client to target micro-segments for growth, price based on risk and avoid high risk credits

Exhibit 1, Source: disguised client analysis

Embedding advanced risk analytics into originations and collections processes

The full journey and transformation typically takes 12-15 months, and now is the time to get going while the recovery is nascent. Execution always starts with building the right team. This means ensuring you have analytically oriented leaders and team members in both the risk and product marketing functions. With incentives aligned on risk and growth, these leaders will set the roadmap and priorities for investing to enhance the data and analytical infrastructure as well as creating the dashboards for tracking, trending and drilling down on all key operational and financial metrics that drive P&L performance. The teams will focus on adapting the processes and controls to integrate the new analytic capabilities into business practices. In order to avoid layering in unnecessary complexity, priorities should be sequenced to streamline end-to-end processes, optimize use of capacity and talent and drive relentless execution.

In building effective analytical teams, leaders need to know "what good looks like" and role model and manage to the supporting behaviors. Key elements include:

- Leaders and managers focused on personnel development, coaching, achieving goals and improvement and innovation
- Right resources aligned and engaged in high impact activities, collaborating within and between functions
- Incentives, rewards and recognition aligned and designed to drive desired behaviors and outcomes

Common challenges that leaders need to recognize and address early on include: Loyal staff but skillsets that have not kept pace with advances in technology and data analytics; Managers acting as firefighters; Frustration over inefficient and low value-added tasks; Everyone feels overloaded.

These challenges often lead to another common execution question: Whether to implement using a "parallel process" or to pursue incremental change? The former CEO of successful auto finance and credit card businesses shared that he would always have the right analytical people in risk and product marketing focused on driving incremental, analytically driven improvements that delivered process efficiencies, which funded growth initiatives and capability enhancements. The answer is relative to the degree of change but should lean towards a bias for action.

Managing to ROI targets for profitability

Successful, analytically driven consumer finance companies like Capital One use ROI targets for profitability as the management framework for decision making. ROI becomes the basis for pricing and targeting loss rates. Specifically, in some cases if pricing becomes an issue to obtain volume based on competition, then managing loss rates to achieve profitability targets becomes more critical. On the other hand, if profitability exceeds targets, then pricing or loss levels can be adjusted to increase the volume of business. Reviews by loan vintage should be conducted monthly with both risk and product marketing leaders. Continuous adjustments to risk models and origination and collections practices are core to this management approach. In following this management framework, the score speaks for itself – the company grows profitability in all phases of the credit cycle by meeting ROI targets for the overall portfolio, each product segment, every channel and each risk segment.

FRANK SUI
Senior Managing Director
+1 646.897.8904
frank.sui@fticonsulting.com

TIM DRAGELIN
Senior Managing Director
+1 704.972.4102
timothy.dragelin@fticonsulting.com

MARK HIGGINS
Senior Managing Director
+35 317.650.870
mark.higgins@fticonsulting.com