Visa Consulting & Analytics

Recalibrating the credit lifecycle

Risk and the COVID-19 pandemic

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The COVID-19 pandemic is having a profound effect on the world of payments.

With global economies struggling to recover, consumer behaviors shifting, and digital adoption accelerating, many aspects of the payments business are impacted.

But for many credit card issuers, it is the sudden jolts to the risk environment that are having the most immediate effect on overall business performance.

In this paper, Visa Consulting & Analytics (VCA) looks across the credit lifecycle and considers the implications for today's risk managers.

Almost every accomplished risk manager will have some experience working through an economic downturn. Some may also have coped with a full-blown economic crisis, such as the global financial crisis of 2008 and 2009. But few will have been prepared for the likely scale of the downturn triggered by the COVID-19 pandemic.

While the full extent of the current crisis is far from clear, it seems likely that the recovery will be steady rather than spectacular.[1] In September 2020, for example, the Organisation for Economic Co-operation and Development reported that output had fallen by more than one-fifth in some advanced and emerging market economies. Assuming the continuation of sporadic local outbreaks, it went on to predict that global GDP would be down by 4.5% for the full year, before picking up by 5% in 2021.[2] On the flipside, government interventions have softened the economic impact. Meanwhile, certain sectors, particularly digital businesses, have been thriving through the pandemic and, as with any period of disruption, there are new opportunities for entrepreneurship.

For credit risk managers, however, it is a perfect storm that has put extreme pressure on all phases of the credit lifecycle, all at the same time. Alongside a shift in the economic fundamentals, there is a dramatic acceleration in the uptake of digital channels, and the likelihood that fraudsters will be taking advantage of the ensuing confusion and distraction. Then, to aggravate matters, there is uncertainty as to how the situation will evolve, how long the pandemic might last, or what the recovery could look like.

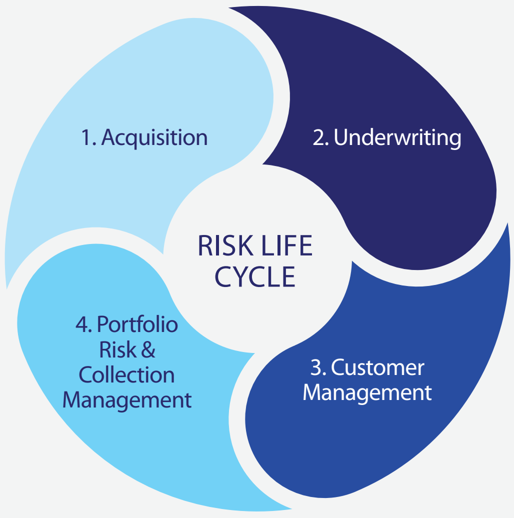
So, what are the main considerations for each phase of the credit lifecycle?

Let us go through them one by one.

The COVID-19 crisis puts extreme pressure on all four phases of the risk cycle

With a shift in the economic fundamentals, there is a need to rethink the risk appetite, tighten the acquisition policy, and reduce the cost of acquisitions.

As new risks materialize, there is a need to rework underwriting models, think harder about risk-based pricing, and pay particular attention to origination fraud.



With increased risk across the portfolio, volume is pushed towards the collections function —which is the final back-stop in protecting performance and reputation.

As customer behaviors evolve, customer management practices must follow suit —including credit line management, repayment plans, authorization management, and fraud detection.

1 Oxford Analytics, "Coronavirus watch as restrictions ease, a slow revival," May 4, 2020, http://resources.oxfordeconomics.com/coronavirus-watch-as-restrictions-ease-a-slow-revival?oe_most_recent_content_download_id=0000029&interests_trending_topics=coronavirus

2 OECD Economic Outlook, Interim Report, 16 September 2020, http://www.oecd.org/economic-outlook/

PHASE 1

Acquisition

The big picture

With a shift in the economic fundamentals, there is a need to rethink the risk appetite, tighten the acquisition policy, and reduce the cost of acquisitions.

The big considerations

The pandemic has shifted the risk profile of acquisitions. A percentage of consumers will inevitably be facing financial hardship and, along with several other strains of COVID-inspired fraud, an increase in application fraud is inevitable.

To compound matters, many of the tools used to assess new applicants will be rendered less useful. Traditional checks may require additional scrutiny and validation. Similarly, the usual methods for verifying income (such as payslips or bank statements) should be viewed with more caution.

Under these circumstances, many issuers may have chosen to close their doors to new applicants, or to limit themselves to the very safest of safe bets. So, for those issuers who are willing to take measured risks, there are bound to be opportunities to grab market share, especially for those who are ready and prepared to act as the tide begins to turn towards a recovery.

The big imperatives

Continue acquisitions, but do so with prudence.

Tighten up your underwriting criteria. Rethink and rework your approach to decisioning. Experiment with new data sources. Focus on measured bets. Also, be sure to construct your credit card propositions in a way that optimizes your credit risk exposure and effectively balances risk with anticipated profitability.

A sound and relatively safe strategy is to pursue deeper, multi-product relationships with existing customers. You already know these customers; you know something about their circumstances and, with the help of your analytics teams, you may be able to deduce much more.

This is also a good time to enhance digital acquisitions. The pandemic has accelerated the shift to digital channels, and your best prospects will expect an elegant, friction-free online application journey. The imaginative deployment of digital technologies can limit your exposure to fraudulent applications through, for example, the use of biometrics.

Meanwhile, through scenario and forecast modeling, you can prepare for the upturn. For example, you could review your acquisition strategy by geographic location, consumer segment, product type, and so on. You can also perform a profitability analysis against different recovery scenarios to identify areas of stress and opportunity. Armed with this type of analysis, you can prepare to exit segments that are not profitable under the different recovery scenarios, and grow in those that hold the most promise.

The critical consideration, however, is timing. If you scale up acquisitions too early, the credit losses could be high. If you come in too late, your competitors will have grabbed market share. Armed with sound analytics, you can be poised and ready to make the right move at the right time.

PHASE 2

Underwriting

The big picture

As new risks materialize, there is a need to rework underwriting models, think harder about risk-based pricing, and pay particular attention to origination fraud.

The big considerations

Generally speaking, credit card customers in the time of COVID will segment into three broad categories: (1) those who are facing a profound shock; (2) those who are getting through a short-term hardship; and (3) those who remain largely unaffected.

The challenge for the credit risk manager is to determine which customers fall into which category, make underwriting decisions accordingly, and follow through with the right credit line assignment and management strategies.

For the first category, tighter underwriting and sound credit line management can help issuers reduce their exposure and mitigate incremental credit losses. For the second and third categories, an overly cautious approach might have the opposite effect, with the potential to undermine customer relationships.

The big imperatives

Many issuers use automated tools and decisioning criteria to streamline underwriting and credit line management. However, strategy assumptions based on past economic conditions may no longer be applicable.

You should therefore reevaluate your approach to underwriting, question the validity of your models, and interrogate the data that underpins them, in order to ensure that your risk tolerance is correctly reflected in the way that customers are decisioned and credit lines are assigned in the current environment.

In particular, your emphasis should shift to scenario-based underwriting and cash flow-based lending models.

For example, as an added protection, you should look for recent proof of cash flow, such as this month's pay slip, or this month's bank statement. In recent years, many issuers may have relaxed their criteria for collecting and checking this type of documentation. Now is the time to tighten things right back up again.

Similarly, you should look carefully both at income sustainability (does the customer work in an at-risk sector?) and affordability (what is the customer's residual income after day-to-day living expenses?).

One thing you should NOT do is set the credit line too low, as this can lead to adverse selection among your new customers. If you have the confidence to originate an account, you should also have confidence to assign a realistic credit limit – one that is useful to and sufficient for the customer.

PHASE 3

Customer Management

3

The big picture

As customer behaviors evolve, customer management practices must follow suit – including credit line management, repayment plans, authorization management, and fraud detection.

The big considerations

From a customer management perspective, the two big areas of consideration must be:

1. **Credit line management –** For many issuers, the knee-jerk reaction may be to rein in all credit limits, but this can be counterproductive. You run the risk of stimulating borrowing among at-risk customers while simultaneously irritating customers who are financially unaffected by the downturn.

2. **Authorization management –** In a time of turmoil, the authorization system acts as a critical last line of defense against heightened risks. Yet, at the same time, the way an issuer chooses to manage its authorizations has a significant impact on the customer's experience. Even at the best of times, declined transactions are a huge market irritant. During the pandemic, when payment choices may be more limited and consumers more stressed, there could be even less tolerance for inappropriate transaction declines.

The big imperatives

Be cautious with credit line management, but do not overreact. This is one of the learnings from the recession of 2008/09, when the first instinct of many issuers was to apply immediate, across-the-board credit limit decreases. Looking back, many will agree that this was a mistake. By drawing attention to available credit lines, it inadvertently stimulated more borrowing by at-risk customers, and irritated everyone else. It is far better to plan a more measured, targeted, and nuanced credit line management strategy, for example, by focusing on cardholders who work in industries most directly impacted by the crisis, and also on those you have already identified as habitual defaulters.

In the case of authorization management, your approach should be a direct reflection of your organization's risk appetite, its customer service ethos, and its digital ambitions. If you have not already done so, you should create an Authorizations Committee integrated by representatives of key teams across the organization and ensure that it is empowered to implement any necessary changes. These could include enhanced customer authentication tools, improved fraud detection measures, updated over-limit strategies, and new customer messaging/alert functions.

Card on file and recurring transactions should be an immediate priority. Policies should be put in place to avoid unnecessarily declined transactions.

The key to identifying and preventing emerging and potential fraud patterns most likely lies within your existing transaction data. Therefore, you should continually challenge your analytics teams to find new insights. Most fundamentally, you will probably want to speed up your reporting cycles, moving from quarterly or monthly to weekly or daily.

In addition, be sure to keep the lines of communication open. Keep your cardholders updated on your policies. Warn them of any issues they may face. Whenever you decline a transaction, tell your customers why; indeed, this can be an opportunity for you to enhance the customer experience, rescue transactions that could otherwise be lost, and build customer loyalty. If the worst happens and an account is compromised, be open and proactive in your customer communications.

PHASE 4

Portfolio Risk & Collection Management

The big picture

With increased risk across the portfolio, volume is pushed towards the collections function – which is the final backstop in protecting performance and reputation.

The big considerations

As issuers deploy portfolio strategies such as proactive line management to limit exposures, or shut down balance transfers and installment plan propositions, transforming the way collections are managed is another important consideration.

Here, the critical success factor is to engage quickly and proactively with at-risk customers in order to achieve three objectives:

1. **Get an early indication of the true severity of a customer's situation** in order to understand what is actually affordable for that customer.
2. **Increase the success rate** so a difficult situation is not left to spiral out of control.
3. **Maintain loyalty** so an at-risk customer comes to value the assistance the issuer is providing, feels good about the issuer, and remains loyal well into the future.

Successfully navigating this path offers you the best opportunity to protect both the profitability of your portfolio and the reputation of your brand.

The big imperatives

The most effective response will vary widely from issuer to issuer and also from country to country. For example, in markets with government stimulus measures in place, delinquencies could be artificially low, and the true severity of the situation may be masked.

However, for most issuers in most markets, the number of accounts in collection is likely to see an increase, which means a squeeze on collections capacity and, most likely, an increase in collections cost. Consequently, as well as growing in-house capacity, it would make sense to shift more business to third parties.

Meanwhile, you should look to automate where you can in order to contain costs. For example, you could explore virtual channels to reach your customers, and provide a self-service tool so they can choose the best option for their needs. You should also force yourself to find new efficiencies, emphasizing non-human touchpoints. A good approach is to build an automated process to reduce manual intervention in areas like case allocation, customer detail updates, feedback capture, and so on. Another useful tactic is to digitize collection payment receipts in order to reduce reconciliation efforts. You can also explore the use of self-service channels to resolve incoming customer queries, such as collection chatbots and new internet and mobile banking functionality.

Overall, the quicker you can engage with an at-risk customer, the higher the success rate is likely to be. Also, the fact that you are reaching out should reflect well on your organization, irrespective of a customer's true circumstances.

When engaging with customers, it is important to be empathetic, listen closely, and adopt the right tone. Successful issuers will be prepared with compliant, affordable, reasonable, and flexible deferral options. Letting customers know that you care and are ready to support them through the crisis will go a long way in protecting and building valuable relationships for both the short-term and the long-term.

In addition, be sure to talk to your analytics teams about leading indicators and collection scores. If customers are starting to experience difficulties, there are bound to be early warning signs in your internal data, especially if a customer holds multiple products with your organization. With this type of intelligence, combined with granular credit bureau data, you can frame collection strategies that will help you prioritize in order to limit your losses and protect your most valuable customer relationships.

While the COVID-19 pandemic has affected businesses everywhere, opportunities can arise from challenging situations. At Visa Consulting & Analytics, we can support your response to the pandemic as the recovery unfolds. To have a more in-depth discussion with VCA, please contact your Visa account representative.

About Visa Consulting & Analytics

We are a global team of hundreds of payments consultants, data scientists and economists across six continents.

- Our consultants are experts in strategy, product, portfolio management, risk, digital and more, with decades of experience in the payments industry.
- Our data scientists are experts in statistics, advanced analytics and machine learning with exclusive access to insights from VisaNet, one of the largest payment networks in the world.
- Our economists understand economic conditions impacting consumer spending and provide unique and timely insights into global spending trends.

The combination of our deep payments consulting expertise, our economic intelligence and our breadth of data allows us to identify actionable insights and recommendations that drive better business decisions.

For help addressing any of the ideas discussed in this paper, please reach out to your Visa Account Executive to schedule time with our Visa Consulting & Analytics team or send an email to **VCA@Visa.com**. You can also visit us at **Visa.com/VCA**.

