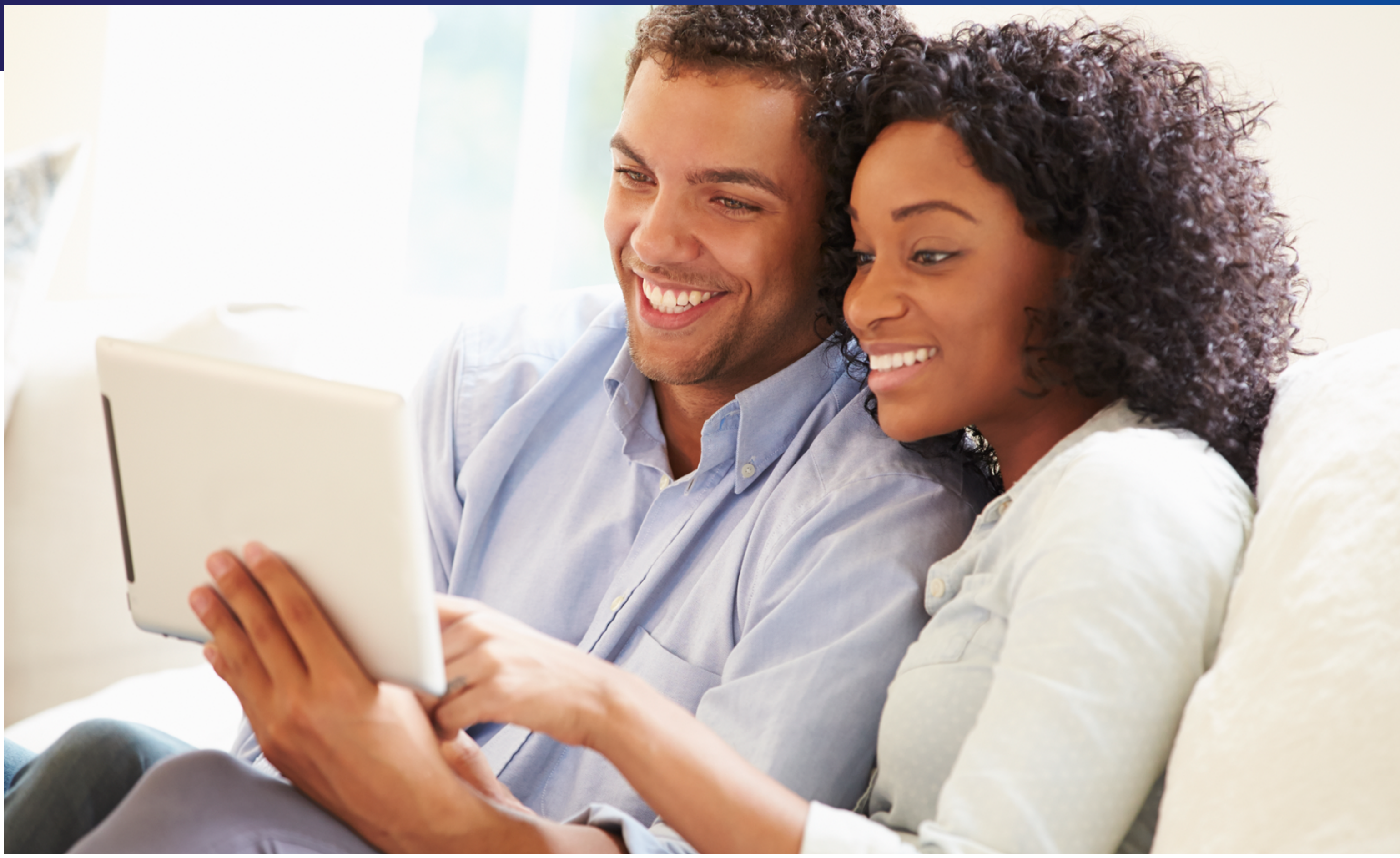
Visa Consulting & Analytics



Assigning and Managing Credit Lines

Risk and the COVID-19 pandemic

VISA

The COVID-19 pandemic represents one of the biggest disruptions in the history of the electronic payments sector.

With GDPs falling, a global recession underway, and a lasting change in consumer behaviors likely, many aspects of electronic payments will be impacted. But, in the short term, it is the sudden shifts in the risk environment that are likely to have a profound effect on overall business performance.

Visa Consulting & Analytics (VCA) has investigated the changing face of electronic payments risk from several angles. In this paper, we consider credit limit assignment and management.

Almost every accomplished risk manager will have some experience of 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. While we have yet to determine the full extent of this unprecedented crisis, what is remarkable is the impact on everyday consumer behaviors.

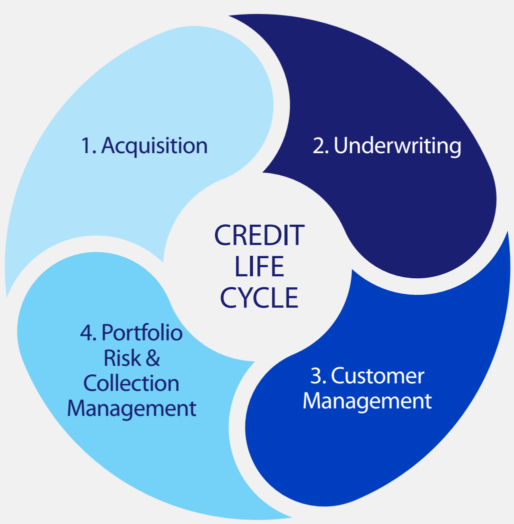
In early May, for example, Oxford Economics reported that global household spending had fallen even further and faster than GDP, and warned that, "when a recovery does come, it is likely to be steady rather than spectacular"[1]. Meanwhile, the pandemic is expected to wipe out the equivalent of 195 million jobs worldwide[2], which is increasing consumer concerns about their ability to pay bills and loans, with a wide gap opening-up between developed countries (with 66% expressing concern) and developing countries (where the equivalent figure is 88%)[3].

For credit risk managers it is a perfect storm. It is putting extreme pressure on all phases of the credit lifecycle, all at the same time. To aggravate matters, there is uncertainty as to how the crisis will evolve, how long it might last, or what the recovery could look like.

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

With a shift in the economic fundamentals, there's a need to re-think the risk appetite, tighten the acquisition policy, and reduce the cost of acquisitions.

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 new risks materialize, there's a need to re-work underwriting models, think harder about risk-based pricing, and pay particular attention to origination fraud.

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 International Labour Organization,"COVID-19: impact could cause equivalent of 195 million job losses, says ILO chief", April 8, 2020: https://news.un.org/en/story/2020/04/1061322
3 TransUnion, "Global COVID-19 Consumer Financial Hardship Study Report", April 2020: https://content.transunion.com/v/financial-hardship-global-report

We are therefore experiencing a deep and sudden shift in credit risk. In the short term, this shift is predicted to have a profound impact on the overall performance of any credit card business. In this paper, we focus on credit line assignment and credit card management – which straddle the second and third stages in the credit lifecycle.

For the credit risk manager, there are three broad categories of consumers to consider:

1 Those who are facing a profound shock

Given the severity of the economic impact of COVID-19, some consumers will face real financial hardship, which may persist well into the future.

Under these circumstances, a rise in delinquencies is perhaps inevitable. One of the best, surest ways for credit card issuers to manage their exposure is through the smart assignment and management of credit limits.

2 Those who are getting through a short-term hardship

For many consumers, the crisis may represent a temporary financial squeeze.

Their earnings may have taken a hit. They may even have lost their job. But, as the crisis recedes and their financial situation stabilizes, they should be capable of servicing their debts – and will likely think well of the financial institutions that provided access to extra liquidity, helped them to bridge the gap, and stood by them in their time of need.

3 Those who have not been affected

These consumers are the lucky ones.

Their finances will not be dramatically affected, and their needs will not have shifted significantly.

The challenge for the credit risk manager is to determine how customers segment into these three categories and to act accordingly with regards to credit line management.

For the first two categories, sound credit line management can help issuers to cut their exposure, and reduce incremental credit losses. For the second and third categories, using credit line management strategies on these customers can have the opposite affect and has the potential to decrease the health of your customer relationships.

The specifics of the response will be determined by the issuer's circumstances, the size and characteristics of its portfolio, the fraud environment in which they operate, and the severity of the crisis in its home markets. VCA has compiled nine imperatives that, we believe, are relevant to any issuer operating anywhere.

Nine imperatives for issuers credit line assignment and management in the COVID-19 pandemic

#1

Credit line assignment:

Be super-prudent on acquisitions

Continue acquisitions, but with prudence.

Tighten-up underwriting criteria. Focus on safe bets. Be sure to construct credit card propositions in a way that limits your credit risk exposure. For example:

- Optimize credit limits – perhaps by dialing-down your usual income multipliers
- Reduce cash advance limits – to address the biggest risk area in a tough economic climate (20-25% of the existing credit line is a good rule of thumb)
- Enhance the underwriting process – perhaps by adding in behavioral scores
- Adjust any usage-based promotions – sloping them more heavily by risk bands
- Tighten-up application fraud processes – to prepare for a likely rise in fraudulent applicants who will ultimately default
- Implement more flexible product structures – to give you access to more tools to better manage higher risk…and enable you to adjust quickly when the recovery begins

There will still be plenty of good opportunities out there. Many issuers will have backed right down from acquisitions, so competition will be less fierce. In particular, there is likely to be a window of vast opportunity just before the inflection point, when the recovery is about to begin. Meanwhile, the strict criteria can always be loosened as the environment improves.

#2

Credit line management:

Understand current-state strategies and develop an enhancement roadmap

Many issuers use automated tools and decisioning criteria to streamline credit line management. However, strategy assumptions based on 10 years of economic growth may no longer be applicable, and could introduce risks into automated strategies.

If you haven't already done so, you should therefore re-evaluate your credit line management strategies, and interrogate the data that underpins them – to ensure that risk tolerance is reflected in how customers are decisioned during the current environment.

Reactive credit line increase programs tend to be risky at the best of times, so may need to be paused. With proactive programs, there is less of a downside, but it is still best to exercise caution – especially with techniques like point of sale lending.

#3

Credit line management:

Don’t react too strongly or too quickly with credit line decreases

This is one of the learnings from the recession of 2008/09.

The first instinct of many issuers was to apply immediate, across-the-board credit limit decreases. Looking back, many will agree that this was an over-reaction, which caused multiple issues. All too often, it led to accelerated spending by at-risk customers as they saw their ‘life line’ quickly disappearing. By drawing attention to available credit lines, it inadvertently stimulated more borrowing – and irritated those customers who were unaffected by the downturn.

Rather than applying any quick reactions, it is better to spend the time on planning 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 those who you know to be habitual defaulters. Also, consider limiting the exposure on inactive accounts, perhaps by tightening up the authorization rules.

#4

Credit line management:

Make it relationship-driven – not just risk-driven

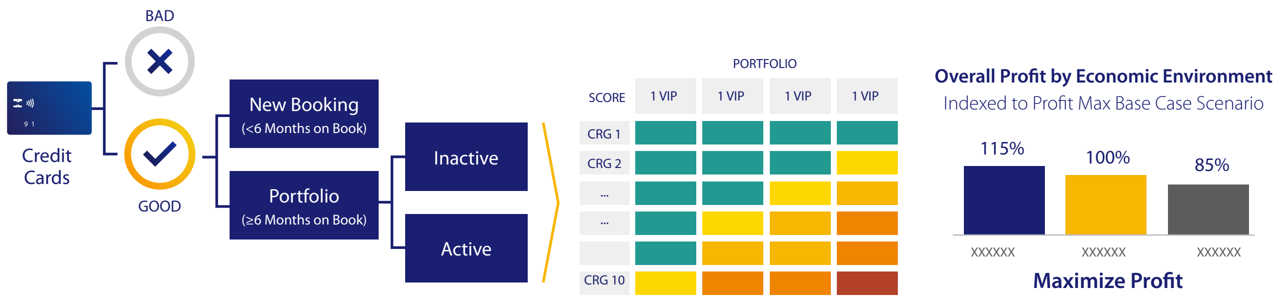
Be sure to segment customers based on the strength of the relationship as well as the severity of the risk.

Start with a behavioral segmentation (considering, for example, new versus established customers, active versus inactive customers, transactors versus revolvers, and so on). Then overlay a risk-based segmentation (making use of both internal data and credit bureau data).

Aim to get as much granularity as possible. Look out for any pre-at-risk indicators. Then focus attention on those at-risk revolvers and credit limit management activity – with a view to understanding and supporting customers before they sink into trouble.

Optimize credit line factoring economic outlook

Sanitized example from client project



#5

Credit line management:

Pay particular attention to cash advance limits

At times like this, cash advance transactions represent the reddest of red flags – because risky borrowers are likely to draw down the full limit before defaulting.

Apply extra scrutiny, especially for the riskier borrower to mitigate risk and protect portfolio profitability.

#6

Credit line management:

Make use of credit bureau batch management data

Some issuers have traditionally drawn on credit bureau data to warn them of silent attrition – because, when an existing cardholder applies for a new credit card from a competing provider, it is an indication that they are likely to defect.

In times like these, the same type of information can be indicative of a different situation – as at-risk borrowers apply to other providers in order to secure more credit.

This is the time to start obtaining this type of data or receive it more frequently and ensure it plays an appropriate role in new strategies.

#7

Credit line management:

Be sure to rein-in over limits

This is the time to revisit your over-limit authorization strategy (when a cardholder account has surpassed its credit limit with a transaction).

Over-limits are a particularly useful tool in today's environment. Increases and decreases in the percentages can be applied quickly, easily, discreetly and cost-effectively. They can also be directed towards specific transaction types – for example, the channel and the merchant category.

Focus on high utilization accounts with the best behavior scores – and conduct a transaction-level profitability analysis to define a new fit-for-COVID over-limit strategy.

Also, if you implement a good profitability construct (with the decision based on profitability of each incremental dollar lent), you should be able to adjust quickly by bumping up your risk factor.

#8

Credit line management:

Increase use of behavioral scores and credit bureau scores

Behavioral and credit bureau scores are a good way to segment portfolios. Use them to develop early risk indicators and adjust credit line management accordingly.

Also, develop specific collections queues for managing over-limit accounts and delinquent accounts. Similarly, introduce credit bureau scores into collections – with a view to developing enhanced COVID-related collections strategies and collections scripts.

Before you dive too far in, be sure to seek some reassurance of how the models are performing. For example, have they been updated or adjusted to reflect the current environment? Are the key drivers stable, even if they cannot yet be fully validated?

#9

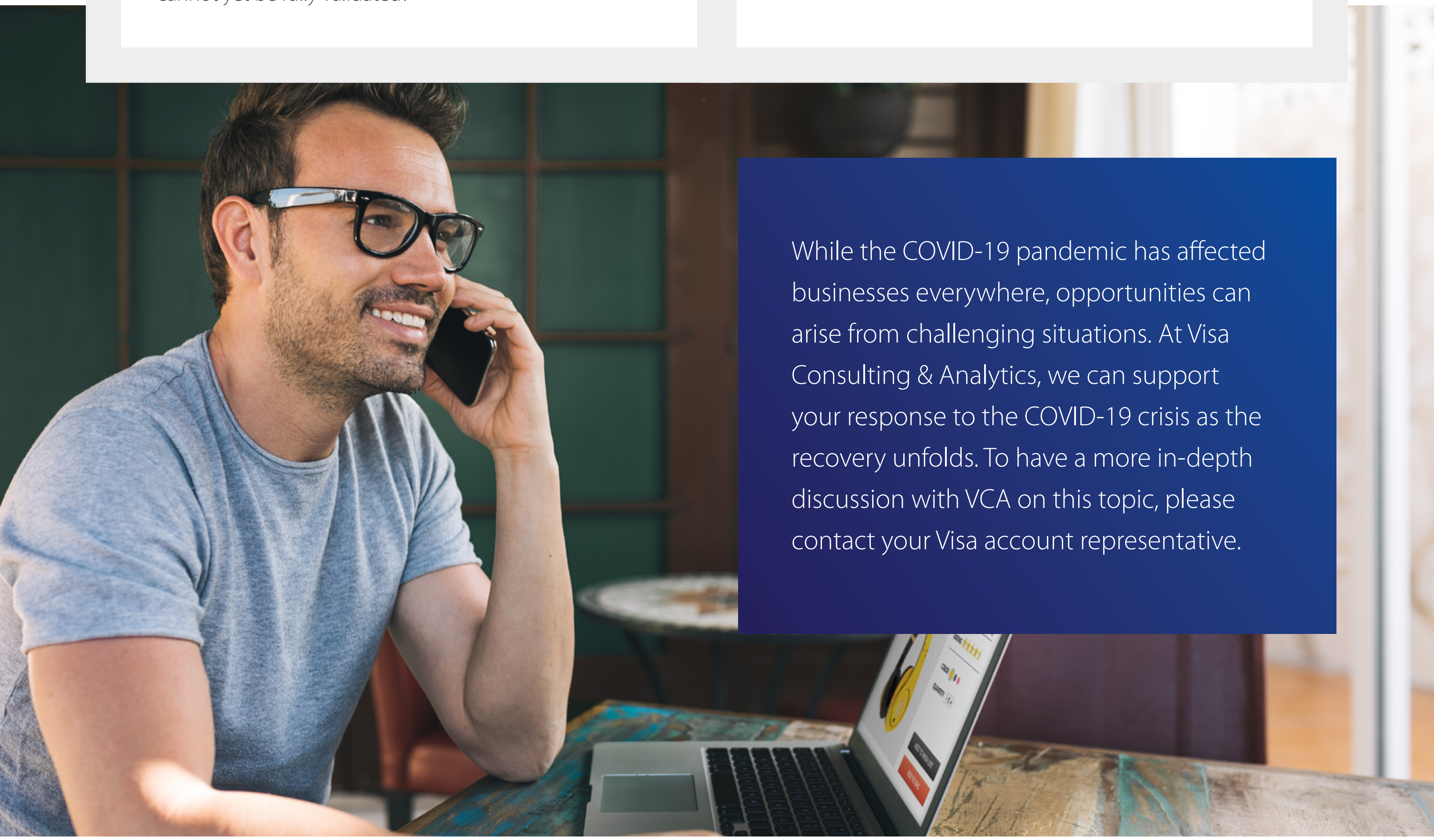
Credit line management:

Frame the message positively

There is no easy way to tell a customer their credit and spending limits are being cut back.

Credit limit decreases should be targeted towards only at-risk customers. Again, these decreases are best used as part of a pre-delinquency program, and used alongside a menu of other affordability solutions such as:

- A focus on repayment
- Offers of instalment programs
- An avoidance of any spend-based promotions



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 COVID-19 crisis as the recovery unfolds. To have a more in-depth discussion with VCA on this topic, 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, 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**.

