White paper

The Next Big One

New preemptive recession readiness strategies to stabilize your organization and avoid the consequences of too little action too late

I. Introduction

The Great Recession lasted from 2008 to mid-2009 and featured the worst financial crash since the 1930s. Recessions have been known to occur every six years or so, on average, and it's been nearly a decade since the last recession ended. Though the current state of the U.S. economy is strong, evidenced by historic low levels of unemployment and high consumer confidence, some economists and financial industry experts suggest the economic outlook may darken in 2020.

To consider a realistic readiness strategy, lenders and financial institutions should consider the next recession a certainty - it's just a question of when. The best time to prepare for a downturn is during the peak months that precede it. To proactively evaluate and act on countercyclical moves of the economy, lenders must prepare to steady their portfolios through loan diversification, strengthen collection capabilities and increase capacity in advance of the inevitable next recession.

A Shift in Perspectives

It might be hard to imagine switching from growth initiatives to the often-difficult collection conversations— especially during the longest period of continued growth on record. In many markets, historically low loss rates led lenders to reduce the size of their collection operations and focus on efficiencies and minimizing costs. But now is the right time to re-evaluate focus; financial institutions that prepare with a preemptive strategy will be the least phased.

Due to the healthy economy and diverse credit products issued, consumer spending — and revolving balances — are on the rise. Bankcard delinquencies also are increasing, according to Experian data.

According to analysis based on the New York Fed Consumer Credit Panel, aggregate household debt balances increased in the third quarter of 2018 for the 17th consecutive quarter and are now $837 billion higher than the previous peak of $12.68 trillion (Q3 2008). Meanwhile, aggregate delinquency rates worsened in the third quarter of 2018. As of September 2018, 4.7 percent of outstanding debt was in some stage of delinquency, an uptick from 4.5 percent in the second quarter and the largest in seven years.

As natural disasters and financial downturns usually are unforeseen, too little strategic action often is taken too late. With loss rates mounting, lenders may suddenly find themselves without adequate tools or staff to address their at-risk accounts effectively. Don't be caught off guard.

Lenders that proactively modernize their business to scale and increase effectiveness before the next economic downturn may avoid struggling to address rising delinquencies when the economy corrects itself. This may improve lenders' portfolio performance and collection capabilities — significantly increasing recoveries, containing costs and sustaining returns.

What do lenders need to do today to adequately prepare for the next economic downturn?

- **Implement risk and behavioral scores** to manage the portfolio and be proactive against rising delinquency.
- Manage portfolios and **flow of accounts into collection** by monitoring changes in observable risk metrics across key segments and subsegments of the portfolio.
- **Develop more extensive data sets** made up of nontraditional and unstructured data; also leverage advanced analytical techniques (including different types of machine learning).
- Build more **accurate and expansive** sets of metrics.

II. What We Learned

It's been more than 10 years since the first rumblings of the Great Recession started in 2008, a stark contrast to today's high levels of consumer confidence. What have we learned over the last decade? And how do our current behaviors compare?

While there are several metrics that performed better in 2018 than 2017, in many ways numbers are still down from where they were in 2008.

10-year Review[3]	2008	2017	2018
Average number of credit cards	3.40	3.06	3.04
Average credit card balances	$7,101	$6,354	$6,506
Average number of retail credit cards	3.03	2.48	2.59
Average retail credit card balances	$1,759	$1,841	$1,901
Average VantageScore®[1]	685	675	680
Average revolving utilization	28%	30%	30%
Average non-mortgage debt[2]	$23,929	$24,706	$25,104
Average mortgage debt	$191,357	$201,811	$208,180
Average 90+ days past-due delinquency rates	7.1%	7.3%	6.7%

[1]VantageScore range is 300 to 850.
[2]Average debt for this study includes all credit cards, auto loans and personal loans/student loans.

In comparison with 10 years ago, the number of retail cards is down, while the average balance is up, according to Experian's annual *State of Credit Report* referenced above. Additionally, the number of credit cards is down for all age groups, as well as credit card balances for consumers 22 to 71 years of age.[3]

Anticipating the Recession

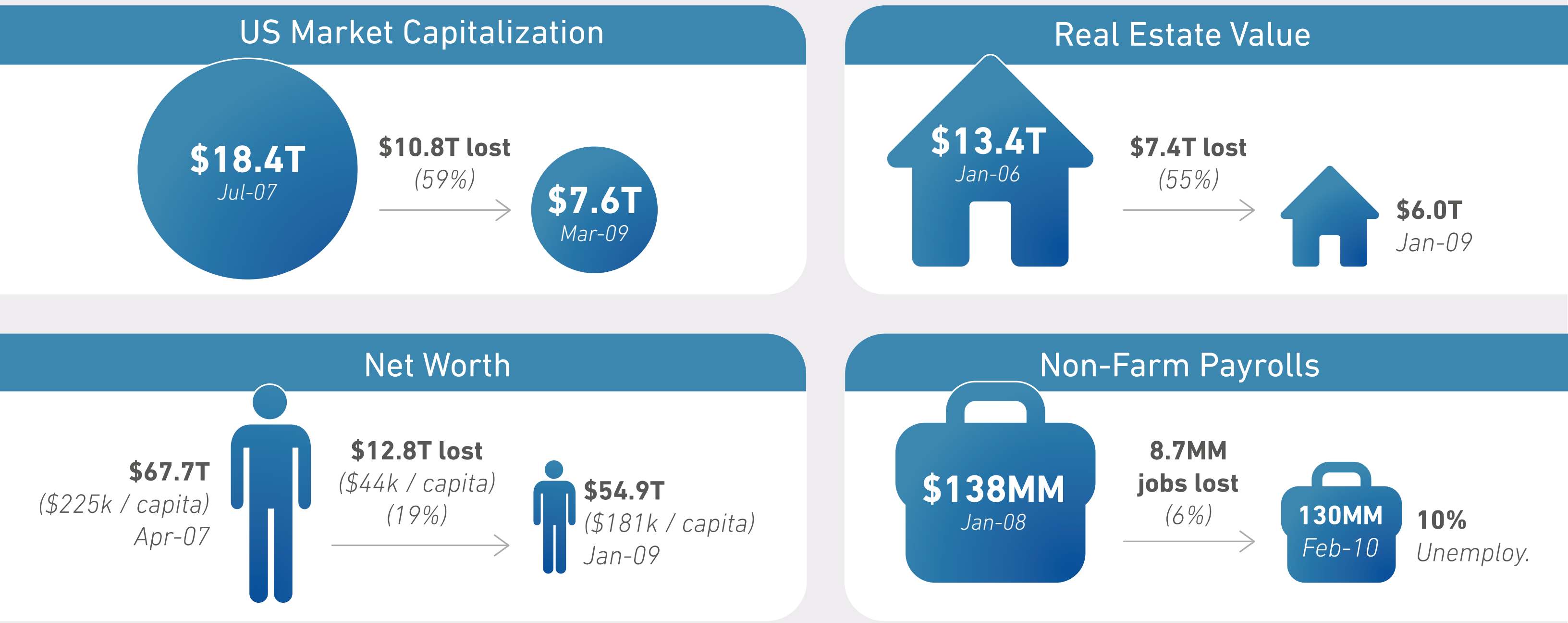
The market has experienced substantial gains with relatively low volatility since mid-2007. But while the risk of a recession has remained low, it has started to edge up.

On March 22, 2019, the yield curve inverted— a shift that disincentivizes lenders to lend. Historically there is typically a correction of the economy within 12 months after the inversion. What does this mean? With a correction also comes a change in priorities for lenders and financial institutions. Originations will likely go down, as will associated marketing and acquisition tools like prescreen. Growth strategies are traded in for cost efficiency.

While there is currently a heavy emphasis on unsecured personal loans and home equity lines of credit, revolving balances are likely to level off as consumers become more stringent with their money. The scale tips toward increasing utilization rates for credit lines, which ultimately leads to an escalation in delinquency rates and collection efforts.

[3]*Experian's State of Credit Report 2018.*

What we learned from 2008: Americans were hit heavily



Source: Bloomberg, Federal Reserve Bank of St. Louis, US Census Bureau, Morgan Stanley

Numerous studies show most Americans are worried a recession will hit this year, and many have already taken actions to prepare.[1] Recession risk is also top-of-mind for C-suite executives, whereas last year it was considered an afterthought, according to *The Conference Board C-Suite Challenge 2019*, Morgan Stanley. Some financial institutions are starting the conversation, but many are not looking at strategies that will benefit them now and when the recession hits. And arguably, different sectors require different considerations.

There is curiosity surrounding how online lenders—aka fintechs — will fare, given that this will be the sector's first economic downturn since many peer-to-peer and other digital lenders emerged after the Great Recession of 2008.

Analysis of federal data reveals that some banks have started pulling back from riskier loans, while credit unions look for different techniques to take a more proactive approach, as past strategies are more than a decade old.[2]

What is the best way to prepare for what could be the next recession?

In 2018, banks turned down almost half of applicants with low credit scores, versus 43 percent at the same time last year. Banks also closed accounts for 7 percent of existing customers overall, with subprime borrowers feeling even more pressure.

Source: http://fortune.com/2018/12/17/banks-loans-recession/

[1]https://www.marketwatch.com/story/more-americans-are-having-trouble-sleeping-and-the-reason-may-keep-you-awake-too-2019-06-27
[2]http://fortune.com/2018/12/17/banks-loans-recession/

III. Cautious is the New Growth

The key to a successful recession readiness philosophy is to prevent and handle bad debt while also managing your portfolio from initial indicators through to internal and external account resolution.

Ideally, lenders should proactively manage their portfolios to minimize the flow of accounts into collection in the first place. As a standard practice, lenders monitor and manage their credit portfolios using methods of varying degrees of sophistication. At the most basic level, they monitor changes in observable risk metrics across key segments and subsegments of the portfolio and take action in cases of rising delinquency. Many of today's lenders also have some form of behavioral scoring and early warning systems in place to help in these efforts.

By using a suite of sophisticated risk and behavioral scores to monitor the portfolio and harness analytics to initiate engagement with customers, lenders and financial institutions can improve performance while also steadying their portfolios. On the wave of the recession, as little variance as possible is the goal. To achieve this, lenders must develop more extensive data sets, including both nontraditional and unstructured data, as well as leverage advanced analytical techniques like different types of machine learning.

IV. Portfolio Mix and Avoiding Collection

Stress testing gives visibility into how your portfolio will perform under different circumstances, including in the tumultuous economic environment of a recession. The ability to identify how portfolios will perform can help financial institutions determine how to go about a plan of action — while carefully considering the customer experience.

Lenders need to start segmenting customers and collection cases (or potential collection cases) initially by exposure, risk and behavioral dimensions— along with capacity and willingness to pay, preferred contact method and preferred channels of intention. This much more differentiated and tailored approach will ensure that resources across the portfolio are allocated in the best way possible, significantly reducing inefficiencies for the financial institution.

What does the ideal portfolio look like?

Economic indicators can have one of three different relationships to the economy: procyclic, countercyclic or acyclic/cycle-neutral.

Procycle (Growth)

Procycle is when an economic quantity is positively correlated with the overall state of the economy. Any quantity that tends to increase in expansion and decrease in a recession is classified as procyclic. This portfolio is focused on growth (credit growth, profit growth).

The trouble with a strictly procyclic reaction to the economy is that it does not allow for forward-thinking behavior that would prepare the market for the declines that will eventually return.

Prospecting

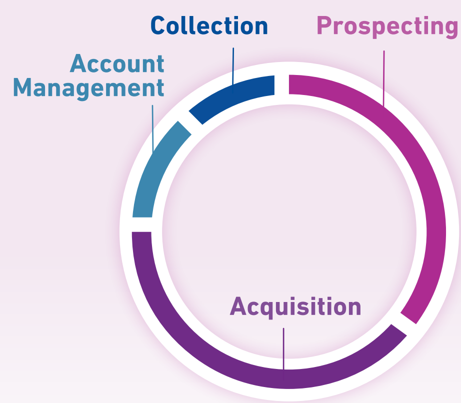
- **Target Effectively —** Likely to open, rebanked, cross-sell, upsell, spend
- **Identify Creditworthy Consumers**
- **Optimize Channel Mix**

Prescreen
Prequalification
Trended Data for Cross-Sell/Upsell
Attributes and Scores
Alternative Credit Data
Decisioning-as-a-Service
Attribute Toolbox
PowerCurve® Strategy Management
Marketswitch Optimization

Acquisitions

- **Improve Underwriting Strategy**
- **Maximize Profitability —** Drive spend, optimize approvals, line assignment and pricing
- **Digital Acquisitions/Conversion**
- **Fraud Prevention**

Powercurve®
Text for Credit™
Decisioning/Machine Learning
PowerCurve® Originations
CrossCore™



Counter-Cycle (Recession)

A counter-cycle features a contraction in economic activity, when an indicator and the economy move in opposite directions. Profits decline and credit is scarce for all economic factors. Monetary policy becomes more accommodative and inventories gradually fall despite low sales levels, setting up for the next recovery.

Collection

- **Regulatory Compliance**
- **Right-Party Contact**
- **Increase Operational Efficiency** — Collection rates and dollars, collected/recoveries
- **Reduce Bad Debt/Charge-offs**

Collection Triggers℠
TrueTrace™
Experian Clear Data Platform™
eResolve™
PowerCurve® Collection
Attribute Toolbox™
Marketswitch Optimization
Mosaic USA
TrueTouch

Account Management

- **Maximize Profitability —** Wallet share, line increase/decrease, profit-based retention, cross-sell
- **Manage Risk —** Risk segmentation, payment stress, early delinquency
- **Account Takeover**
- **Identity Theft Protection**

Archives
CrossCore™
Experian Analytical Sandbox™
Risk & Retention Triggers
Portfolio Health Check℠
PowerCurve® Customer Management

Cycle-Neutral (Independent)

Cycle-Neutral is when an indicator has no relation to the health of the economy; economic activity remains in a steady, constant state.

Prospecting

- **Right Target Population —** Cross-sell, upsell, criteria analysis, offer messaging, spend
- **Identify Creditworthy Consumers**

Trended data
Alternative credit data
Credit reports
Attributes and scores

Account Management

- **Maximize Profitability —** Wallet share, line increase/decrease, profit-based retention, cross-sell
- **Manage Risk —** Risk segmentation, payment stress, early delinquency

Archives
Analytical sandbox
Risk and retention triggers
Quest℠/Express Quest
CLIP

Financial institutions that arm themselves with the right tools as economic indicators present themselves may remain ahead of the curve with agile strategy changes and minimize the flow of customers who go into collection during an economic downturn.

V. Collection — Optimizing for the Consumer's Worst-Case Scenario

While it's never an easy conversation, collection is the scenario you need to prepare for. And arguably it has the most takeaways from the last recession. When it comes to collection, it's imperative to keep the customer experience in mind, in addition to recovering dollars.

As many institutions have cut head count in the collection department — with recovery needs being minimal during the past years of growth — creating efficiencies in debt collection should be a priority.
Analytics-based customer segmentation is at the center of the next-generation collection model. This model allows lenders to move away from decision-making based on static classifications, whether these are standard delinquency stages or simple risk scores.

It is difficult to optimize collection if the customer cannot be contacted or profiled, no matter how sophisticated the implemented strategies or treatments. Many lenders struggle with the availability and quality of information on borrowers, often including basic contact information. Frequently, banks fail to make successful contact with half of the accounts that are charged off.

A portion of these may be linked to fraudulent activity or belong to customers declaring bankruptcy, but many are charged off simply because collectors were unable to make contact. Some customers in this group are not actively avoiding contact; rather, they were not contacted due to poor onboarding or faulty skip tracing. However, it is worth the effort to contact these customers properly, since they may be willing to pay (or not).

In some cases, this data deficiency is a symptom of a siloed organizational structure, where servicing functions do not focus on the data needs of collection. In other cases, the absence of borrower data is simply due to a lack of a robust data management strategy. Limited borrower data forces collection teams to attempt to locate information on the borrower after delinquency when information could be more easily and accurately collected prior to the delinquency.

The collection process today impacts your portfolio tomorrow

Experian® analyzed the impact of traditional collection methods and found that 3 percent of 30-day delinquencies in card portfolios closed their accounts after paying their balance in full. And 75 percent of those closures came shortly after the account became current. Additionally, the propensity to close accounts was four times higher in the young, urban, affluent population than in others. This could disrupt your portfolio in the long term.

Ramping Up for the Recession

When the economy is in recession, it's often synonymous with some of the darker aspects of finance — including foreclosures, strapped credit lines and collections. While the ultimate philosophy is one of prevention, should your customers go into collection due to financial struggles, there are ways to optimize your process to maximize your efforts.

Remember, a dollar of loss prevented is a dollar of profit - specifically during a recession.

Strategies today incorporate technologies and approaches that were unavailable when the Great Recession hit. The most important advances are being enabled by advanced analytics and machine learning. These powerful digital innovations are transforming collection operations by helping to improve performance at a lower cost and to better understand customer preferences.

The collection process is driven by the measurement of delinquency and loss, without considering the broader consumer profile. Too often, this narrow view leads to one-size-fits-all collection strategies and overly aggressive processes.

The linear approach, which is often based on the number of days past due and a few additional dimensions (including balance and risk), is not enough. Although this method has been used with a reasonable degree of success in the past, it does not recognize that a contact strategy and treatment plan that works well for one type of customer may not work for another (i.e., a customer who has simply forgotten to make a payment versus someone dealing with a financial hardship). This deeper level of insight can help financial institutions and lenders create a more personalized message and engage individuals in their preferred channels to optimize collection efforts while preserving valuable customer relationships that enrich the quality of your customer base.

Stage-focused
Little or no individualized treatment

Customer-focused
Highly individualized treatment

Collection Activity	Chase the Account	Understand the Customer	Treat the Person
Use of Data	Limited view (account balance, credit history, score)	Extended view (monthly cash flow, transaction history)	Complete view (behavioral, demographic, emerging)
Process Type	Linear, step-by-step process	Based on segments (e.g., level of risk)	Next-best action; based on analytically driven decisions
Customer Interactions	Traditional (call center, letters)	Multichannel (web, mobile)	Omnichannel (digital, self-service, virtual agents)
Customer Treatment	Little concern about fair or suitable treatment	Proactive treatment to help prevent delinquency	Highly individualized based on a full view of the customer

Minimize Fraud Exposure

Fraud can present numerous risks to a financial institution's bottom line at any time in the customer life cycle, but especially during the collection process. Organizations need to continuously monitor their portfolios throughout the life cycle to detect and address any suspicious activity. Debt management treatment strategies must be tailored to and aligned with fraud risk type. The segmentation of fraud risk type based on a breadth of data assets and advanced analytics is paramount to optimized action paths.

VI. Conclusion and Solutions

The next “big one” is coming — and the time to prepare is now. Investing in a recession-ready strategy will steady your organization and deliver sustained performance throughout the next recession. On top of portfolio performance, financial institutions will be able to improve the customer experience over the long term.

Collection strategies leveraging the latest technology and advanced analytics facilitate streamlined performance and higher ROI. By connecting with consumers through their preferred channels and creating personalized experiences, financial institutions can experience increased recovery rates, adding value to customer loyalties.

Experian helps with current and future needs, specifically as they relate to recession readiness. With the most comprehensive data — and a 99.9 percent accuracy rate — we are the data partner you can count on. With industry-leading attributes, scores and decisioning systems, you can take your segmentation strategy to the next level, enabling financial institutions to not only prepare for, but also thrive during and after the next recession.

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