Trends in portfolio management

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Executive summary

The economy is slowly accelerating, although economists, government officials and daily headlines indicate the acceleration is stronger in some sectors than others. Consumer and economic data shows that many consumers are struggling to pay their debt, particularly credit cards, home equity and mortgage loans. So how does a lender manage their loan portfolio to stay abreast of emerging credit problems and identify those customers who are more favorable when it comes to extending credit? Lenders must look even more frequently and much more closely at their loan portfolio and "dig in" to consumers' behavior to set short-term portfolio management strategies.

Business barometers

The prevailing point of view is that it's not the best of times and it's not the worst of times. It's simply a difficult time to predict how well consumers will fare paying their credit card, home-equity and home mortgage loans in the coming year. However risk managers' jobs depend on gaining such knowledge, especially at a time when the economy is rebounding slowly and still encountering new challenges along the way. Paying close attention to current market dynamics and consumer credit behavioral trends are keys to success.

Fortunately, sophisticated analysis of consumer loan repayments and other economic barometers offer a clearer picture of what 2012 should look like allowing managers to focus more carefully on their portfolio performance.

First, closely watched business indicators are signaling that the economic upturn will prove a slow one. Don't expect any business burst or even burble. Here's why.

- The nation's jobless rate continues to hover around 9 percent, although the rate fell to 8.6 percent in November 2011, and there are still about 7.5 million fewer workers today than before the recession began in 2007. As of November 2011, 13.3 million Americans were unemployed.[1] This portends a slow economic rebound.
- Consumer sentiment tumbled in March 2011 by nearly 12 percent, according to the Conference Board's monthly report. Consumers' inflation expectations rose significantly during the month and their income expectations soured,[2] a combination that likely will affect consumers' spending decisions.

[1]U.S. Bureau of Labor Statistics, December 2, 2011.
[2]The Conference Board, March 29, 2011

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- The average U.S. consumer is 45 percent poorer today because of the recession, a Federal Reserve Board survey indicates.[3] The decline reflects the falling values of Americans' homes, cars and financial assets such as stocks and retirement accounts. During the recession, the median family's net worth fell 23 percent from $125,000 to $96,000.[4] And in the last decade, median income has slid 8.1 percent.
- As for consumer prices, they increased 0.5 percent in February, seasonally adjusted, and the rise was broad-based, although gasoline and fresh vegetables and meats climbed more sharply.[5] Consumers are worried about inflation, as a result of the hike in commodity prices and in gasoline prices since the Middle East unrest began this year.

Consumer credit behavior

Consumer credit-related data — including deeper analyses by Experian — suggests that consumer behavior is improving but at an uneven pace, indicating that any real improvement will come later.

Charge-offs of credit card debt eased to 9.4 percent in the fourth quarter of 2010 from the record 10.1 percent recorded in the third quarter of 2009, a survey by CardHub.com showed.[6] But the latest quarterly rate still was more than double the 4 percent rate in the fourth quarter of 2006, a year before the recession began. In February 2011, a Moody's Investors Service survey showed, charge-offs of credit card debt edged up from January's rate.[7]

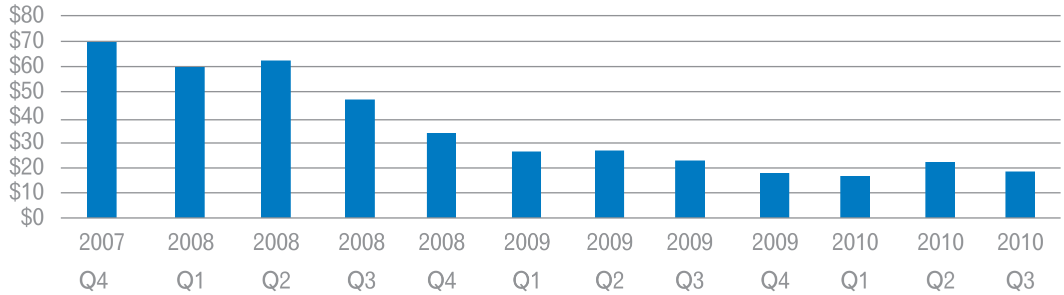
Still, loan delinquency was a mixed bag. The rate at which accounts were 30 days or more behind on payments declined for the 16th consecutive month — to 4.02 percent from 4.1 percent and the lowest level since August 2007. However, "early-stage" delinquency — accounts at least 60 days behind — rose slightly, Moody's reported.[8]

New home-equity and bankcard accounts have been stable recently, pointing to some easing in lending practices. In the third quarter of 2010, for instance, new home-equity account originations fell slightly to nearly $19 billion from $22 billion the previous quarter (Figure 1).[9] However, this is still higher than the first quarter 2010 origination amount of $17 billion.

[3]Federal Reserve Board study, "Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009," March 24, 2011
[4]Ibid
[5]U.S. Bureau of Labor Statistics, March 17, 2011
[6]CardHub.com, Federal Reserve data
[7]Moody's Investors Service, March 22, 2011
[8]Ibid
[9]Source: Experian data

Figure 1: Home equity originations

Origination volume (limits)
(in $billions)



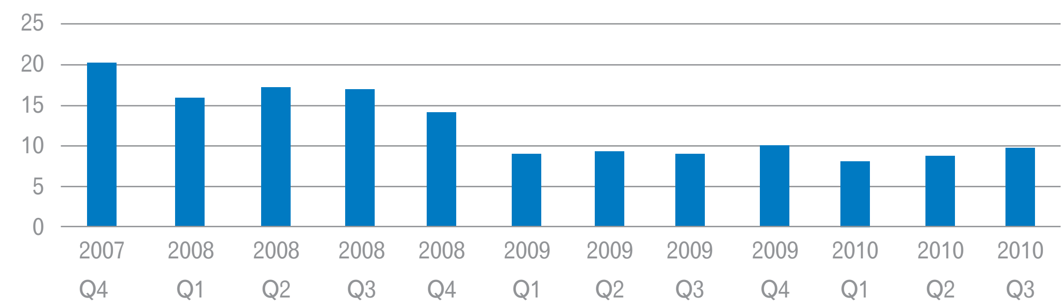
	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3
■	$70	$60	$63	$47	$33	$26	$26	$23	$18	$17	$22	$19

Home equity line originations have remained low, yet stable for past 2 years — after a steep drop in 2008 resulted in an over 50 percent decline in new limits

New bank cards issued rose to 9.8 million in the third quarter of 2010, up from 8.8 million the prior period and 8.2 million in the first quarter of 2010 (figure 2).[10] Still, millions of consumers have stopped using bank-issued credit cards. The decline chiefly reflects consumers trying to maintain healthy credit-card relationships, analysts say. In addition, card issuers tighter lending policies impact this.

Figure 2: New bankcard accounts

Number of new bankcard accounts
(in millions)



	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3
■	20.3	15.9	17.1	16.9	14.0	9.2	9.3	9.0	9.9	8.2	8.8	9.8

Interestingly, new bankcard volumes increased again in Q3 2010, as 9.8 million new cards opened in the quarter (up from 8.8 million in Q2 2010)

[10] *Source: Experian data*

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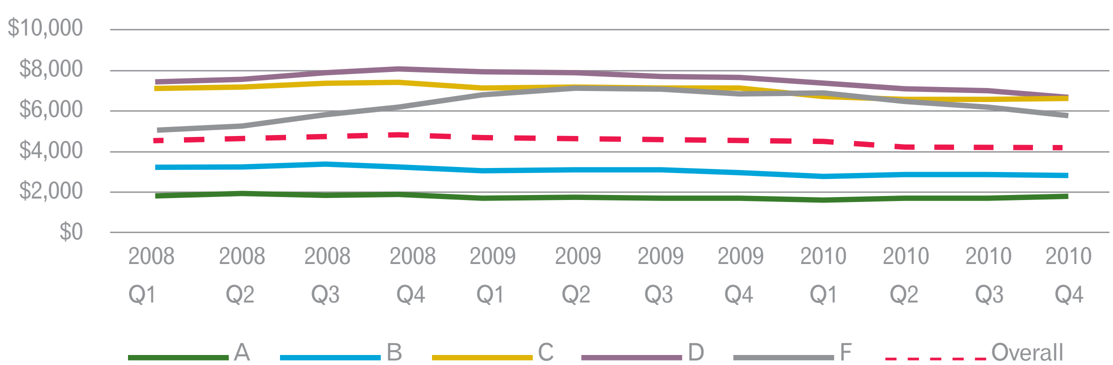
The recent expansion in lending probably reflects, in part, the decline in bankcard balances by consumers in nonprime VantageScore[11] tiers (see appendix), which begin with scores of 700 or below, and an increase for consumers in the highest prime VantageScores, tiers, those above 800. In the fourth quarter of 2010, the average bankcard balance for the riskiest holders, those with VantageScores of 600 or below, declined to $5,865 from $6,245 the previous quarter. For the next group of nonprime consumers, those with scores from 601–700, their average balance has dropped for six quarters in a row, to the latest balance of $6,768 (Figure 3).[12]

Meanwhile, the average balance per consumer with a score of 901 or above increased for the third quarter in a row, to $1,789 in the fourth quarter of 2010 from $1,585 in the first three months of 2010. The average balance for consumers with scores of 801 to 900 edged up to $2,886 in the last quarter of 2010 from $2,877 the previous quarter (Figure 3).[13]

Figure 3: Average balance per consumer by VantageScore tier

Balance per consumer with product by VantageScore
(in $dollars)



$1,821	$1,862	$1,827	$1,783	$1,646	$1,709	$1,714	$1,745	$1,585	$1,665	$1.729	$1,789
$3,225	$3,271	$3,306	$3,201	$3,046	$3,035	$3,002	$2,973	$2,860	$2,838	$2,877	$2,886
$7,285	$7,357	$7,550	$7,514	$7,293	$7,309	$7,250	$7,191	$6,885	$6,714	$6,704	$6,644
$7,617	$7,694	$7,990	$8,168	$8,103	$7,998	$7,916	$7,823	$7,551	$7,237	$7,012	$6,768
$5,098	$5,360	$5,775	$6,283	$6,905	$7,104	$7,164	$6,996	$6,998	$6,604	$6,245	$5,865
$4,588	$4,649	$4,773	$4,827	$4,742	$4,761	$4,723	$4,677	$4,444	$4,327	$4,291	$4,246

Interestingly, average balances increased for VantageScore A and B borrowers (again), yet decreased for all higher-risk score tiers

[11]VantageScore® is owned by VantageScore Solutions, LLC.
[12]Source: Experian data
[13]Source: Experian data

Consumer bankruptcy trends suggest the economy won't be helped by any downturn in such filings until at least 2012. Non-business, consumer bankruptcies again rose in 2010, by 9 percent from 2009 levels to more than 1.5 million from 1.4 million, according to data from the National Bankruptcy Research Center. However, the 2010 number was below the 1.6 million bankruptcies that the American Bankruptcy Institute anticipated; the Institute expects another rise — the seventh in a row — in 2011.[14]

As for mortgage foreclosures, they also don't signify encouraging trends. One million homes were repossessed by mortgage lenders in 2010, according to an estimate by Realty Trac, a company that tracks foreclosure activity. This year is on track for a projected 1.2 million foreclosures, Realty Trac predicted.[15]

Reflecting the consumer– and economic–related data, what should risk managers examine more closely to determine their portfolio strategies for the rest of 2012? Frankly, it's just too difficult to look beyond this year.

Here are several steps risk managers should be considering:

- Use all consumer information when making decisions. Nowadays, a risk manager can't afford to bypass any data reported about a customer.
- Since new loan originations have been slowing rather than growing, lenders' existing customer relationships are more important than ever. Lenders should be keeping tabs on them more closely, and many —– even the largest ones — just aren't doing that. Lenders are advised to use some sort of daily triggering system and not wait until monthly data emerges. Experian provides such daily triggers to lenders, giving them a list each morning of its consumers who have reported a bankruptcy, a repossession or a loan delinquency.
- Look at past-due debt data more frequently and place more weight on those consumers on the portfolio who are keeping up with their debt payments.
- Examine those consumers who are delinquent on their home mortgage payments.

[14] *American Bankruptcy Institute study, July 2, 2010; forecast made in January 2011*
[15] *Realty Trac, January 11, 2011*

- Assess all different lending instruments and closely monitor the events that trigger a credit advisory. When Experian examined the various events being reported, 90 percent of them had to do with mortgages and late payments. Mortgage-delinquency experience has become extremely predictive of consumers' bankcard payment behavior. If consumers are suddenly late with mortgage payments, they're probably very late in their credit-card payments. For instance, the chart below lists the most predictive industry events that identify when a bankcard customer is most likely to default. Based on Experian research, key events dramatically increase the bad rate, or likelihood of going 60 days or more past due (DPD) on a bankcard. (Figure 4)[16]

Figure 4: Bankcard consumer delinquency by performance on other financial products

Prime bankcard key events by other products	Bad rate
Collection bankcard	96.2%
90 DPD 2nd mortgage	92.7%
150 DPD 1st mortgage	92.4%
90 DPD 1st mortgage	91.2%
120 DPD 1st mortgage	90.8%
180 DPD 1st mortgage	90.4%
120 DPD 2nd mortgage	90.1%
150 DPD 2nd mortgage	89.4%
60 DPD 1st mortgage	89.1%
180 DPD 2nd mortgage	88.2%

- Follow credit-reporting developments closely. A tradeline item on a credit report refers to a past or present credit relationship for vehicle loans, credit cards, mortgages, leases and other loans. A credit report lists separate tradelines for each account or credit-card number, whether open or closed. A seasoned tradeline is one that's current with a history of timely payments. Also, public record items such as bankruptcy and court Judgments and tax liens are key to understanding the full picture of risk.
- So if a lender reports a tradeline development for a consumer that has changed for the worse from a traditional pattern, that account should be flagged. It's likely that the consumer is facing debt problems. More lenders are reporting tradeline bankruptcies than in the past. One thing lenders can do in such situations is review a consumer's line of credit immediately and make adjustments depending on the situation. Lenders can and are shrinking lines of credit when debt-repayment concerns arise. For example, on a prime bankcard portfolio,

[16]*Source: Experian data*

certain events signal when a consumer may be headed towards more severe delinquency. Based on Experian research, the following elements signal increasing risk for consumers with a bankcard on a combination of public record and performance on other credit trades. (Figure 5)

- Sample historical credit data more often and, if benchmarks exist, base lending strategies on changes in those samples.

Figure 5: Prime bankcard most predictive risk events

Prime bankcard key risk events: Overall most predictive	
Bankruptcy chapter 7 petition	Highest Risk
Bankruptcy chapter 13 petition	
Past due 150 days	
Past due 180 days	
Past due 120 days	
Past due 90 days	
Past due 60 days	
Deed in lieu/foreclosure started	
Tradeline bankruptcy	
Bankruptcy chapter 11 petition	

Conclusion

For the remainder of 2012, the consumer and economic data doesn't imply much change in consumer behavior. Some federal regulations are coming out in the bankcard arena, and others with more far-reaching implications are expected in the mortgage-lending area.

U.S. banking regulators in late March signaled their intention to require lenders to offer mortgages with a 20 percent down payment if they want to repackage the loans to sell to other investors without keeping some of the risk on their books.[17] The bankcard rules, however, are more operational in nature and shouldn't have much impact on how risk managers oversee their portfolios.

[17]Seven bank regulators approved proposed rules and sent out for comment, March 29, 2011

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What about 2012? It's hard to predict. But there are steps to follow to make a real difference. Therefore, stick with refreshing your data monthly and making predictive decisions based on the most recent information. Also because consumers with a prime VantageScore have been saturated by lenders, these lenders have to look to their customers with nonprime scores for any new-loan growth. This means that lenders will have to dissect their nonprime customers more precisely to identify those who should have healthier repayment histories than others.

That's a murky area, of course — much like predictions for the rest of 2011.

Appendix

VantageScore Information

VantageScore,℠ which is both used by lenders and now available to consumers, is the first credit score developed cooperatively by Experian and the other national credit reporting companies.

As a frame of reference, all of risk segments referenced are scored using VantageScore.

VantageScore uses a 5-grade scale, from A through F. Each letter corresponds with a 100-point risk tier, referred to as follows:

A — superprime

B — prime

C — near prime

D — subprime

F — deep subprime

The split between prime and non-prime occurs between the D and C score bands, or 700 and above for prime and below 700 for non prime consumers

Vantage Score Grade	
A (901–990)	Prime
B (801–900)	
C (701–800)	
D (601–700)	Non-Prime
E (501–800)	

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