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REAL INSIGHTS FROM REAL DATA:

Profit Watch

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Lenders can wade back into the water -- if they have the means to separate the sharks from the dolphins …

MAKING IT SAFE TO GO BACK IN THE WATER: How Banks Can Start Lending Again

The economy won't really get moving until banks begin to lend again, but many are understandably reluctant. When traditional approaches for predicting credit risk and cleaning existing portfolios no longer work, lenders can't see what's lurking in the water. And once shark-bit, twice shy.

We have been working with many large financial institutions during this credit crisis, applying three important principles that are allowing banks to collect more on their existing defaults and rebuild profitable consumer lending businesses:

1. ***Lenders can predict credit risk, but they need new models.*** Many lenders find it difficult to separate good credit prospects from bad because they are still basing their risk assessments on "before-the-world-turned" models. These models score consumers on data that are as old as 24 months, and still count all homeownership as a plus. But consumers' situations go south in days and weeks now, not months, and owning highly leveraged real estate can actually increase one's risk of default. The answer: recalibrate models with new predictive data like real estate risk, use more up-to-date information such as defaults on external accounts, and rerun models more frequently. These techniques pay off very quickly. For one lender, overlaying the loan-to-value ratio of a consumer's total real estate holdings on basic FICO scores has allowed them to rapidly identify 20 to 30 percent more customers with very high default probability, so they can avoid the highest-risk loans, but still offer credit to customers with better profiles.

2. ***Lenders have to act fast at the first sign of trouble.*** It's critical to identify at-risk customers as early as possible, and move quickly against defaulters – or recapture rates will be lower. Think of it: most people really don't want to default, and they continue to pay their creditors until the money runs out. For example, we found that during the 30+ days it took our client to initiate collections, fully a third of their defaulting customers continued to pay other creditors. Our client's month-long set up delay meant they ultimately received a lower share of a defaulter's payback wallet. Taking rapid action requires better early warning systems and more nimble credit operations. Collections organizations need timely and comprehensive ways to collect and assess customers' internal AND external payment and default behavior, and then move rapidly at early signs of trouble.

3. ***Matching solutions to the situation improves recovery returns.*** Fitting recovery solutions to individual borrowers can significantly improve collection results. Today, for instance, many previous good customers with sterling payment records have defaulted. Accounting for as many as 25 percent of those targeted for adverse action, these borrowers are highly likely to cure if lenders apply "recovery" strategies aimed at nurturing them back to financial health. For this class of debtors, recovery approaches cost less, recapture more money, and breed amazing loyalty. And returning good customers to the economy is a significant beneficial by-product to everyone. But lenders must recognize that a high-touch "recovery" approach isn't effective for all: about 30 percent of defaulters cost more to pursue than they are worth, and another 20 percent will cure with minimal intervention. The trick is to determine to which segment a debtor belongs. That's where a new class of predictive modeling, based on the latest advances in computational neuroscience, can help. These cutting-edge approaches significantly improve lenders' ability to predict debtor behavior. This, in turn, allows them to apply the right treatments, use scarce collections resources where they can generate the best returns, and stop wasting effort on those who don't need treatment, or won't respond to it.

Given their rising default levels, it's no wonder that banks have lost a bit of confidence in their ability to identify risk and manage their portfolios. But new predictive models, coupled with more complete and up-to-date data and a more finely segmented approach to collections, may make them feel like testing the waters once again.