ForeSight

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Credit Card Management: Seven Strategies to Take Advantage of the Growth Wave

As revolving debt grows, credit card issuers need to be certain their business is properly positioned.

Revolving debt in the U.S. will hit a historic high in 2017. In this ForeSight, Mercator Advisory Group presents a Continuum of Effective Credit Card Portfolio Management—seven strategies for issuers to keep pace with the revenue opportunities for long-term portfolio gains.

by Brian Riley,
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Introduction

The recent recession took its toll on the U.S. credit card business, causing billion dollar credit losses at each of the top tier issuers, shattering reserves that carried revenue to offset losses, and disrupting the cadence of lending, which had been growing steadily at a rate between 6% and 8%. The aggregate portfolio shrank as the recession persisted and it took lenders four years to get back to a meaningful growth pace, evidenced by minimal change between 2010, when the aggregated receivables sat at $839 billion, and 2014, when it ended at $858 billion.

U.S. card issuers are now wearing their lending hats. As we saw, Mercator Advisory Group sees a growth path between 2017 and 2018 continuing the nearly 10% growth we saw between 2014 and 2016. And as momentum builds, we caution that the fundamentals of credit management must be reviewed by issuers large and small. Here are some facts to consider:

- Although consumer bankruptcies in the U.S. were down nearly 7% to 793,932 for the fiscal year ending June 2016 and the percentage of accounts 90 days or more delinquent is at a 10-year low at 7%, a growing portfolio can mask many credit problems.
- With more than 450 million active accounts, and a run rate of 360 million new credit card inquiries based on data from the Federal Reserve Consumer Credit Panel and Equifax, it is likely that 1 in every 4 accounts is less than one year old.
- Contingent liability, the amount of all credit lines were they to be fully used, peaked at nearly $4 trillion during the height of the recession in 2009, then sharply declined to less than $3 trillion in 2011. It is on a steady course to hit $3.5 trillion in 2017, suggesting that increased trends in revolving debt and unused credit availability might create a hidden vulnerability to loan loss reserves.
- Trends on aggregated U.S. consumer debt indicate rapid growth of 169% for persons aged 67 and older in the measurement period between 2003 and 2015, a period in which credit card debt declined by 12% among those aged 39. This contrast suggests that the credit card industry must position itself for riskier credit situations and less growth potential as younger cardholders are less receptive to debt and older cardholders bulk up liability.

Related Concerns

If you find this piece of interest and would like to explore this issue further, possible proprietary project work could be done to examine questions like these:

Which new data and analytic approaches can help you address new account underwriting?

How can you evaluate infrastructure weaknesses to limit risk?

What are the most profitable strategies for you to capitalize on the current account acquisition environment?

How can you best invest in collections and recoveries infrastructure?

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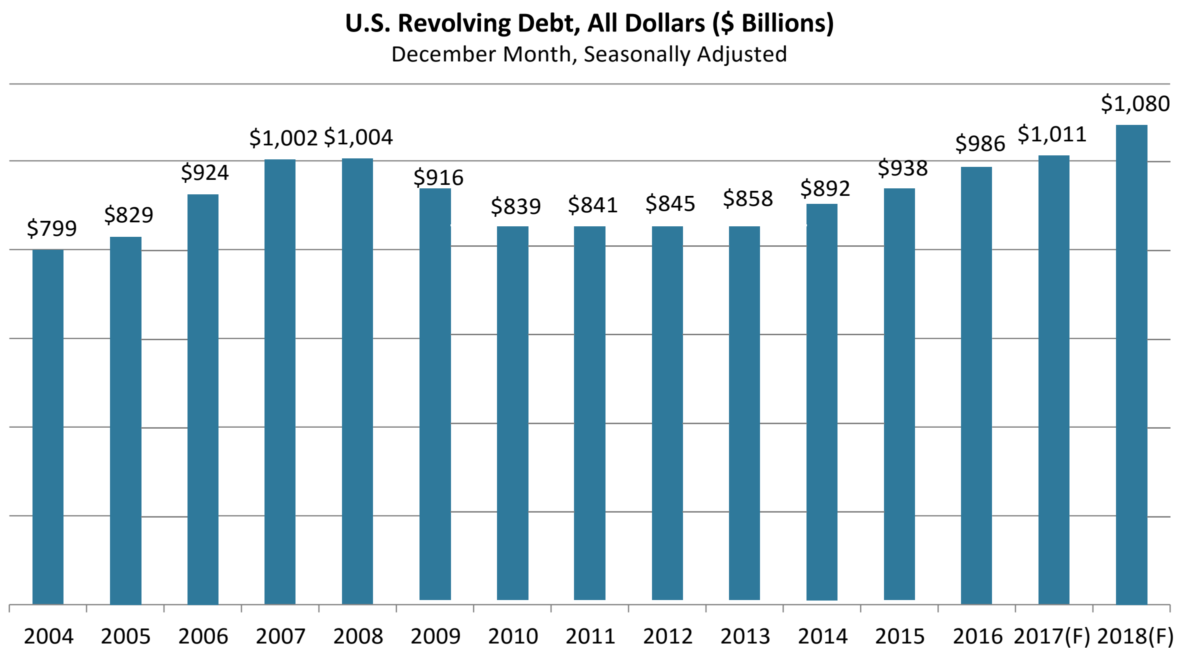
As it stands today, the U.S. credit card business is in relatively good health when measured by growth and credit losses, but be advised that complacency is not in order. Mercator Advisory Group believes that the industry must focus on credit management fundamentals, with an emphasis on bridling growth at the acquisition point, managing portfolio components, and focusing on risk management for both fraud and operational loss. This Viewpoint document outlines Mercator Advisory Group's view of the credit management continuum, discusses the value chain, and suggests a set of action items for the issuers.

Back to the Business of Lending

U.S. Sets a High-Water Mark for Revolving Debt

U.S. revolving debt will surpass the $1 trillion mark again in 2017. It has now fully rebounded from the 2008–2009 recession, when volumes peaked at $1.004 trillion and then plummeted more than $160 billion to $839 billion in 2010. The significance in returning to $1 trillion of outstanding debt is more than measuring the market in 13 digits. It is symbolic of a more confident consumer market and aggressive lending by both small and large network-branded lenders. Figure 1 presents a summary of the Federal Reserve G-19 Report, which generally covers credit cards, along with Mercator Advisory Group's projections.

Figure 1: U.S. Revolving Debt, 2004–2018(F)



Source: Mercator Advisory Group analysis of Federal Reserve Data

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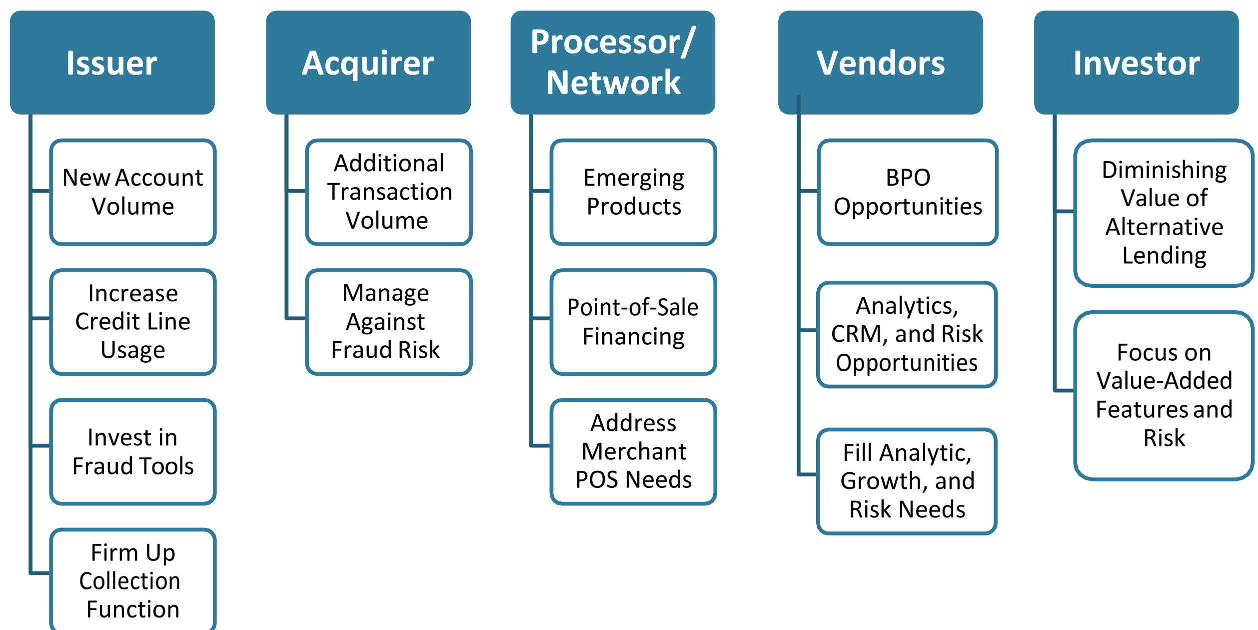
The reduction in debt between 2010 and 2011 was the steepest decline since the Federal Reserve began tracking the data in 1968, when the metric indicated that revolving debt was merely $1.8 billion. Increases were previously steady as the U.S. credit card business matured from an elite financial tool to a mass market product in the hands of most households, where it drives more than $4 trillion in consumer spending annually. About 25% of the total spending revolves (carries forward for extended payment), which is the basis for this tracking.

Growth Affects the Value Chain

Continued growth of receivables affects the entire value chain, from credit card issuing banks to financial technology (fintech) companies and their investors. For the issuer, it brings new account volume, increased credit line utilization, and revenue, but new volumes also increase the risk of application fraud and credit losses.

Figure 2: Value Chain Considerations in a Growing Credit Environment



Source: Mercator Advisory Group

Acquirers, the companies that facilitate card acceptance at the physical point of sale (POS) and for e-commerce, must prepare for additional card volume. They must also prepare for the risk of card-not present (CNP) fraud experienced by the industry in e-commerce.

Processors and networks should be on guard for competition from emerging payment technologies that might disintermediate branded networks, such as point-of-sale financing (POSF), retailer financing, and peer-to-peer lending (marketplace lending platforms). POSF can displace the traditional card by offering immediate credit that diverts the transaction to a specific installment lending contract.

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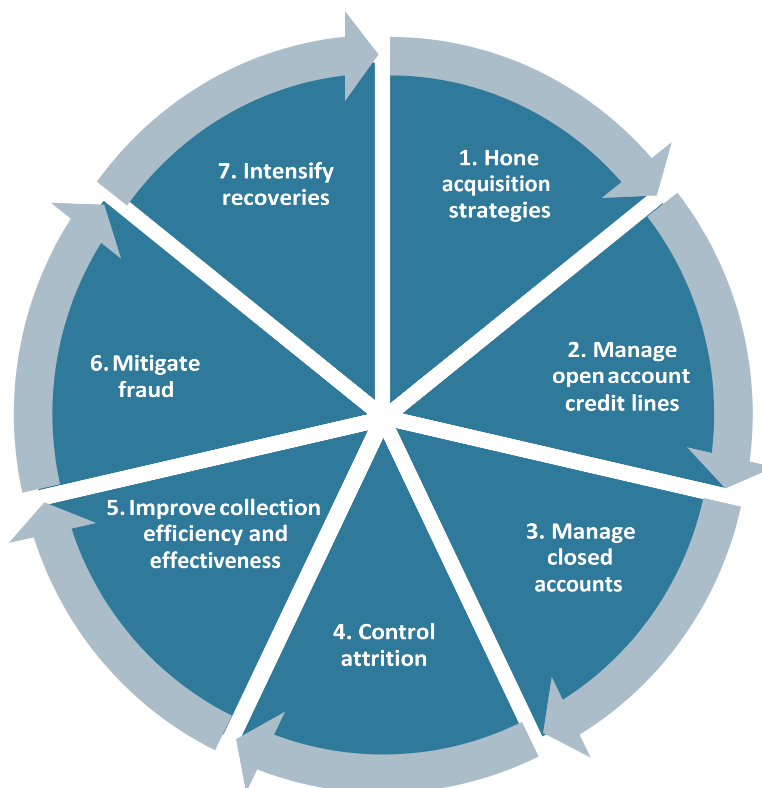
Vendors will find opportunities for business process outsourcing (BPO), particularly to support diversion of call center volume during overflow. Other vendor opportunities center on analytic support, customer relationship management (CRM), and risk management. From a software perspective, analytic and risk tools are business essentials for card issuers. At the end of the value chain are investors, both stockholders and venture capital firms, who should observe the growth in card lending and simultaneous floundering of alternative lending and recognize it as a sign of a reversion by borrowers to more traditional lending sources. Other opportunities exist in the space for value-added transaction features as well as risk management and analytics software.

The Focus Is Credit Quality

Growth Means Risk When Infrastructure Is Weak

The calculus of credit card profitability relies on the ability to lend and price according to risk, and on the ability to manage the portfolio from acquisition through final account payment. Figure 3 presents Mercator Advisory Group's continuum of seven essential steps necessary for an effective strategy to manage the credit cycle. The steps are explained on the next page.

Figure 3: A Continuum of Effective Credit Card Portfolio Management



Source: Mercator Advisory Group

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1. **Hone acquisition strategies.** More and more issuers use the internet channel to source accounts. In fact at the top tier, Chase reports the digital channel was accountable for more than 75% of new accounts it booked. Issuers of all sizes should consider their options, whether they use on-premises software or the services of portfolio platform providers. Onboarding should also seize this channel, integrating a post- mailer card verification channel that gets the customer onboarded through the website at the earliest point in the relationship. Pricing the customer appropriately based on risk considerations is another essential aspect of this step, particularly in light of regulatory constraints against dynamic pricing, which was eliminated under the Credit Card Accountability Responsibility and Disclosure Act (CARD Act) of 2009.

2. **Manage open account credit lines.** On average, cardholders use only about 30% of their available credit line, often leaving a cushion for emergency spending or sometimes having a disciplined approach to household budgeting. Routine assessment of whether a cardholder is worthy of additional credit is an important way to ensure the customer actively uses the card. Ability to pay is easily determined by checking credit scores with the national credit reporting agencies

3. **Manage closed accounts.** It is commonly accepted that a closed account with a balance performs worse than an open account with available credit, but there are pockets of customers who lost their account due to delinquency but now have their financial life back on course and are creditworthy. Routine processes to mine the receivable with portfolio analytic tools to reopen accounts under controlled circumstances offer revenue opportunities and foster customer loyalty.

4. **Control attrition.** Attrition comes in two forms, voluntary and involuntary. In the case of voluntary attrition, cardholders choose to close their accounts. In the case of involuntary attrition, the issuer closes the account usually due to delinquency or mishandling. The latter suggests that an effective collection process can help keep the customer out of trouble before the account typically gets blocked at 60 days delinquent. On a combined basis, attrition often reduces the number of accounts by 15% annually, causing issuers to carry the expense of replacing the accounts to keep the portfolio value on par. With the cost of acquiring a new account running between $250 and $300, and even more when issuers place introductory rewards and incentives on top, simple statement message reminders and interactive offerings on the website can help reduce account attrition in an efficient manner.

5. **Improve collection efficiency and effectiveness.** A good collection process applies the appropriate effort on a specific account to improve collection. Improving collections is more a strategy of helping the customer realize the importance of prompt payment than one of invoking fear in the customer (the latter will likely cause the customers to stop taking calls). The Collections department can couple an attrition management strategy with the incentive of the future availability of credit as a tool to retain the account.

6. **Mitigate fraud.** Fraud takes the path of least resistance. With EMV chip cards now near universal levels, counterfeit card fraud has been supplanted by card-not-present fraud, which is growing at a fast pace. Fraud mitigation requires specific technologies that add layers of protection to shield against third-party use, account takeover, and application fraud.

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7. **Intensify recoveries.** Issuers write off accounts to bad debt status when the account is 185 days past due. Leading up to the write-off event is a series of progressively aggressive phone and mail dunning tactics. Once an account triggers write-off, the account is cast off the issuer's books and the balance is charged to bad debt expense, one of the largest controllable expense line items in a card issuer's financials. Well-designed recovery strategies are highly profitable to issuers because the dollars collected directly generate income rather than simply generating interest and paying down principal. In the case of recovering a $3,500 balance, that single recovery action can generate as much income as the revenue of 100 active accounts, which on average generate $33 dollars in monthly revenue.

Taking Action

To implement Mercator's Continuum of Effective Credit Card Portfolio Management, we suggest card issuers take 15 specific actions that execute the seven strategies outlined above. These actions are listed at right in Table 1.

Table 1: Implementing the Seven Strategies to Take Advantage of the Credit Card Growth Wave

Impact	Strategy	Affected Areas			Action
		Revenue per Account	Risk Management	Portfolio Growth	
ACQUISITION	**Hone acquisition strategies**	✓	✓	✓	• Manage APR pricing • Deter application fraud • Onboard effectively
PORTFOLIO	**Manage open credit lines**	✓		✓	• Quarterly credit line increase reviews
	Manage closed accounts	✓		✓	• Routine review to reactivate closed accounts
	Control attrition	✓		✓	• Balance transfer program • Exit interviews • Proactive management
RISK	**Improve collection effectiveness and efficiency**	✓	✓		• Test dunning strategies • Check calling metrics • BPO contingency
	Mitigate fraud	✓	✓		• Review every strategy • Upgrade to latest software
	Intensify recoveries	✓	✓		• Audit for weak in-house efforts • Generate value

Source: Mercator Advisory Group

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Honing the Acquisition Function

To improve the acquisition function, Mercator Advisory Group suggests focusing on three tasks: managing APR pricing, deterring application fraud, and onboarding accounts effectively. Large banks often use internal underwriting models, and platform service providers such as First Data, FIS, Fiserv, and TSYS typically offer services to eliminate the burdens of back-office management. Card issuers that choose to handle the function directly should ensure that the process flow is not encumbered with too many interest rate variations that require manual attention in the underwriting phase. Three specific annual percentage rates, such as 14.9%, 18.9%, and 23.3%, serve underwriters better than a wide range of APRs that get individually computed in underwriting, such as 12% to 26%.

Deterring application fraud is particularly important as transaction volumes grow and EMV matures in the market. Application fraud is far less of a problem with credit unions, who typically know their members in advance of acquisition, but it requires a prudent effort when accounts are sourced through direct mail or the internet.

The onboarding process should push the customer to the digital channel early in the relationship. The account activation can require the creation of an online account and require additional contact information as well as pushing the account toward digital statements and solicitation for other banking products.

Improving Portfolio Performance

Ensuring that the customer has sufficient credit line is essential to ensure a loyal cardholder. Routinized credit line increase programs provide room for usage beyond what cardholders reserve for potential life circumstances where they may need access to credit. Common portfolio analytic tools can easily select target groups of accounts such as those customers who pay their bills on time but are at 70% of their credit limit. Other efforts, such as a winter holiday program that increases open lines by 20%, can provide lift to most card portfolios. The inverse is also appropriate. Many customers have a high credit line, such as $7,500, but use only a small fraction. This poses a risk to the issuer. Lowering the credit line for a customer in this category would eliminate the possibility of usage of the card when some life event negatively affects the customer’s ability to repay.

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Closed accounts are another area meriting focus. Collection departments typically block the account from purchasing at 60 days' delinquent and close the account to future charging at 90 days' delinquent. Using tools native to the operating platform, or a portfolio management tool, the credit manager can identify accounts that were closed but now have a continuous pattern of repayment, representing another pool of accounts that potentially should have access to credit.

Controlling Risk Management

Effective collection management is an essential function of a well-run credit card portfolio. Three metrics provide insight into the health of a portfolio.

- Accounts missing their payment in the current month
- Cardholders flowing from one collection level to the next, such as 60 days delinquent to 90 days
- The number of accounts aging to write-off as a percentage of the receivable

A growing credit portfolio provides an excellent test bed for perfecting collection strategies. Although some portfolios vary because of underwriting and prior account handling, issuers should stress test their processes as portfolios grow so as to ensure that the strategies in place are effective and efficient. For example, sending collection notices out earlier in the collection cycle, such as at 38 days instead of 45, could reduce call volume and make cardholders more likely to pay before the end of the billing cycle. Similarly, something as simple as changing the text on collection notices, or the color of the paper, could attract a customer's attention enough to generate a payment. Taking action to revitalize the collection function will improve performance and position as the portfolio continues to grow. It is also a good time to consider the use of business process outsourcing, or BPO, firms either to add collection capacity or to direct accounts that show a low propensity to repay.

Similarly, the fraud function warrants a review to ensure that not only the latest versions of anti-fraud software are in place but also proper controls that cover the transaction at the authorization point, account integrity, and channel management. Channel management is increasingly important as transactions shift to digital and mobile, which pose both risk and opportunity.

The final area of review is the recoveries process, an area often neglected because accounts are off the issuer's books and do not present an immediate risk of contractual write-off. These receivables can be large income generators for financial institutions when managed effectively. Typically, 3.5% of an issuer's receivables age to write-off status annually, although the recent recession saw this level running as high as 12%. Rather than holding these accounts waiting for customers to repay, more aggressive strategies use contingent collection agencies, litigation firms, or place the accounts out for sale. Time is of the essence because of the statute of limitations, which varies from state to state. In Massachusetts, for example, creditors have 6 years from the date of last payment to begin collection; and while the limit in Kentucky is 15 years, residents of Delaware find their debt prohibited from collection after only 3 years.

Conclusions

The U.S. credit card business rebounded from the recession and is back in a growth mode. Issuers must position their credit acquisition, portfolio management, and risk functions to take advantage of revenue opportunities and react in a changing world. The strategies outlined in this document are offered as a practical guide.

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