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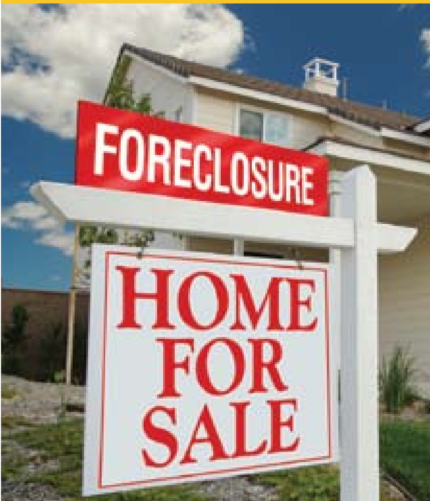

Are today's market pressures reshaping credit risk?

New study explores FICO® Score trends in dynamic times—and how lenders can respond

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In turbulent economic times, financial services firms often tighten the credit reins and refocus on risk. But with growing consumer debt and continued fallout from the credit crisis, many are questioning the effectiveness of today's lending strategies.

As rising debt leads to defaults, financial services clients are turning to FICO with concerns such as: Why are my delinquencies increasing, even for lower-risk segments? Why is a 680 FICO® Score performing like a 650?

FICO conducted a performance analysis to understand potential changes in FICO® Score risk patterns. This paper highlights the most significant findings and provides guidance for best practices.

This begs the broader question: Are today's economic pressures changing the credit risk patterns underlying FICO® Scores—and if so, how should lenders respond?

FICO set out to understand and quantify potential changes in risk dynamics. We conducted a FICO® Score performance analysis, comparing data samples across several time periods reflecting different economic conditions. This paper highlights our most significant research findings and provides guidance for best practices, given what we saw.

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» Research results: key takeaways

Lenders experiencing increased delinquencies should know that they are not alone. Our performance analysis showed:

- **Consumer risk is rising industry-wide**, across lending products and score ranges.
- **Segments with the greatest risk increases largely reflect market pressures.** We see greater risk, for instance, for new mortgage accounts, and select states hit harder by unemployment, falling home prices and speculative investing. These groups are likely impacting overall portfolio charge-off rates.
- **Despite increasing risk, many risk predictors remain stable—with notable exceptions.** Consumers with multiple mortgages, for example, are still less risky than those with none or fewer mortgages—but are comparatively riskier than before. Later in the paper, we'll discuss the more pronounced changes to risk indicators that lenders should keep an eye on.
- **FICO® Scores continue to rank-order risk**—in other words, the higher the score, the lower the risk. This holds true on a general population, as well as specifically for bankcards, auto and mortgage risk prediction.

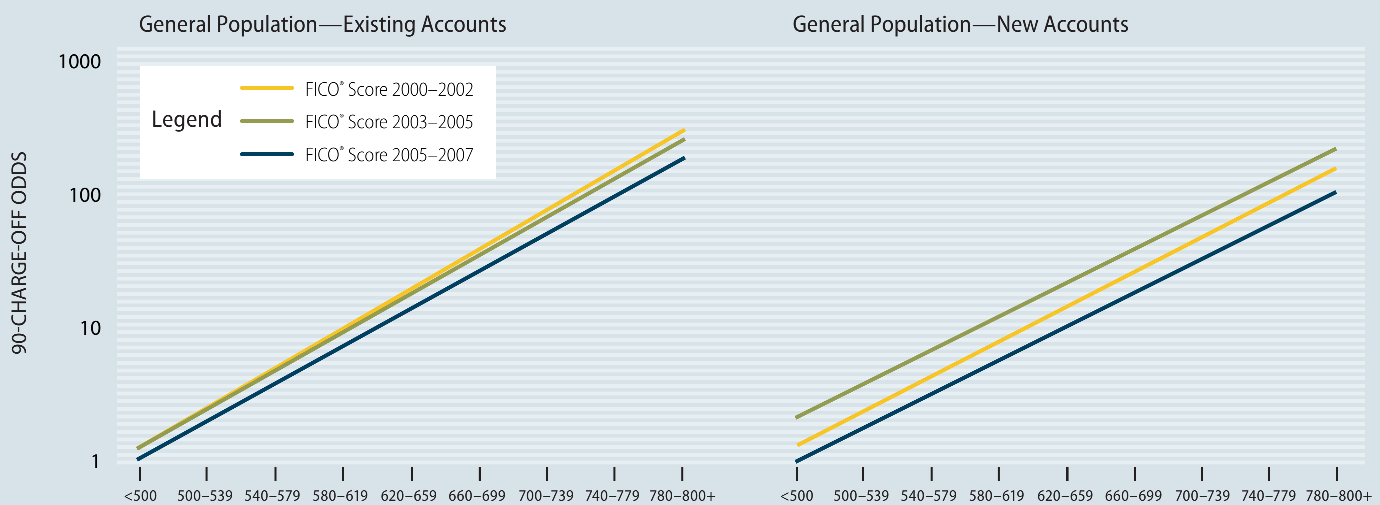
Let's explore these findings in more detail, including a focused look at risk trends for consumers with mortgage loans.

» Credit risk on the rise

To assess overall risk trends, FICO researchers analyzed FICO® Score performance by comparing 2000–2002, 2003–2005 and 2005–2007 credit bureau data samples. The earliest period incorporates performance impacts from 9-11 and the dot-com collapse; the middle period reflects the economic boom driven by the mortgage industry; and the most recent vintage reflects the early indication of increasing defaults and other fallout of the prior mortgage and refinance boom.

We used odds-to-score rankings to explore how relationships differed over the time periods. In other words, at a given score, were charge-off odds shifting higher, lower or staying the same?

Figure 1: Risk increase greater in recent vintage of new accounts[1]



Industry-wide, the 2005–2007 new accounts show greater risk compared to the previous vintages. The lower the line, the worse the odds, which translates into greater risk.

[1] *New accounts include consumers that opened new credit accounts in the six months following the 2000, 2003 and 2005 score dates. Existing accounts include those that opened accounts prior to the score dates.*

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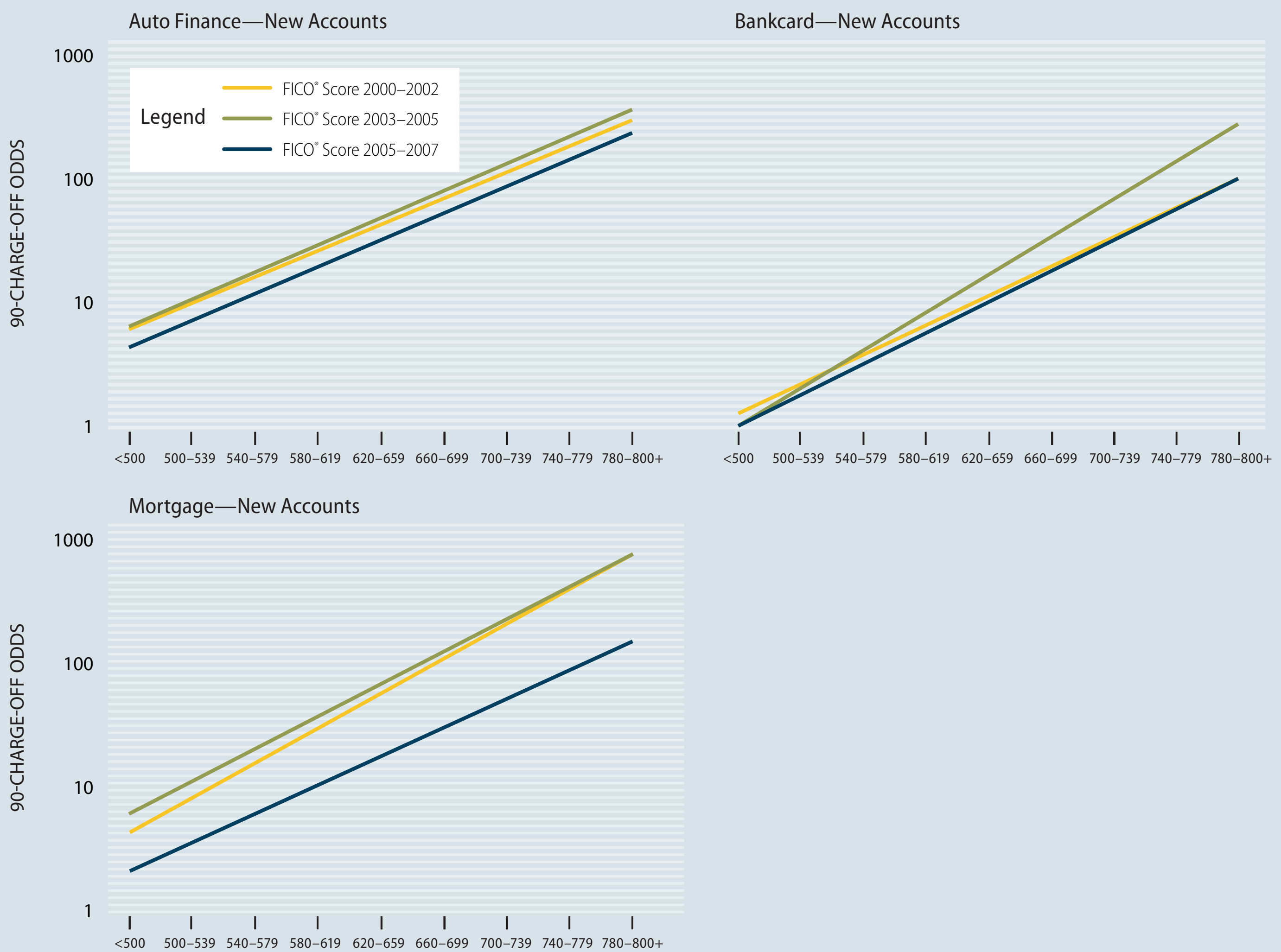
US credit risk has indeed risen industry-wide, as well as within bankcards, auto and mortgage.

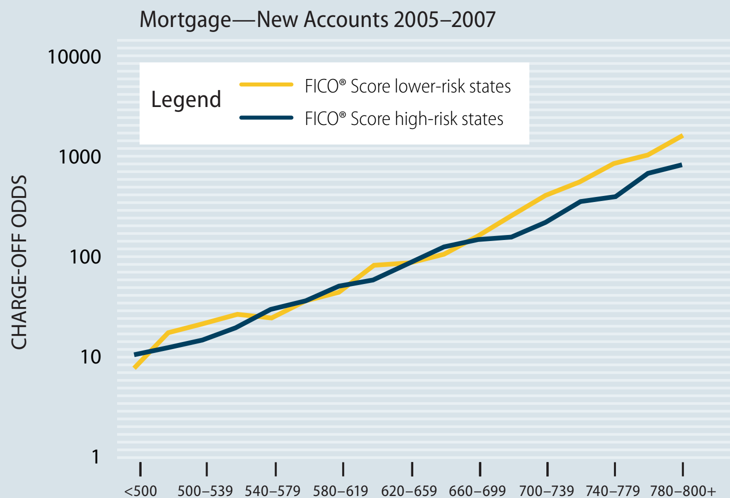
Risk has increased in the most recent vintage for both existing and new account segments of the general population (see Figure 1 previous page). On average, the odds have shifted about 10 points lower for existing accounts in 2005–2007 compared to the previous samples. The movement is more noticeable on the new account segment, where odds have shifted about 30 points lower when compared to 2003–2005, and 15 points lower when compared to 2000–2002.

This trend holds true across industry verticals for the new account segment (Figure 2). Lender strategies and decisions enacted during the time of each vintage within each industry vertical would have had a large impact on the performance observed. The risk increase is greatest for new mortgage accounts, but is also observed for new bankcards and auto loans. Looking at the 2005–2007 data:

- **For new auto accounts,** the odds-to-score relationship has shifted about 30 points lower when compared to 2003–2005, and 15 points lower when compared to 2000–2002.



New auto, bankcard and mortgage accounts in 2005–2007 show greater risk of charge-off compared to the previous vintages, with the greatest increases observed in new mortgages.



In the 2005–2007 sample, consumers opening new mortgages that reside in higher-risk states show greater risk in the higher FICO® Score ranges compared to consumers opening mortgages in lower-risk states.

- **For new bankcard accounts,** the odds-to-score relationship has shifted about 20 points lower when compared to 2003–2005, and 5 points lower when compared to 2000–2002.
- **For new mortgage accounts**, the odds-to-score relationship has shifted about 80 points lower when compared to 2003–2005, and 70 points lower when compared to 2000–2002.

FICO evaluated performance of states that many in the industry would consider higher risk—Ohio and Michigan due to high unemployment, and California, Florida, Arizona and Nevada for mortgage fallout. Figure 3 shows the increases in risk for these higher-risk states compared to the rest of the nation.

Despite the overall risk increases, the analysis demonstrates that the FICO® Score continues to effectively rank-order risk in the different time periods. The results also show that the odds at a given score range can shift over time, as lender practices evolve and economic conditions change. Lenders should frequently monitor and track this dynamic on their portfolios and adjust scoring strategies accordingly.

» Impact of mortgage risk across lending

Given the growing risk of new mortgage accounts, FICO decided to further evaluate FICO® Score performance for consumers with mortgages. Has recent industry volatility changed general credit risk patterns?

Historically, consumers with multiple mortgages have been less risky than those with none or fewer mortgages. These consumers often have the assets and financial savvy necessary for property investment. And prior to the mortgage boom, lenders used more stringent underwriting criteria, especially for those purchasing non-owner-occupied properties.

But after an era of piggyback home loans and with property values falling below consumers' equity, some are walking away from their properties. Once a consumer's credit is tarnished by foreclosure, there is less incentive to maintain good credit ratings with other creditors.

To better understand the impact of these trends, we evaluated whether risk patterns were changing for consumers with multiple mortgages across the 2003–2005 and 2005–2007 time periods.

Multiple mortgage holders are still less risky than those with none or fewer mortgages—but risk is increasing in the 2005–2007 data. This is particularly noticeable for new accounts (Figure 4 next page).

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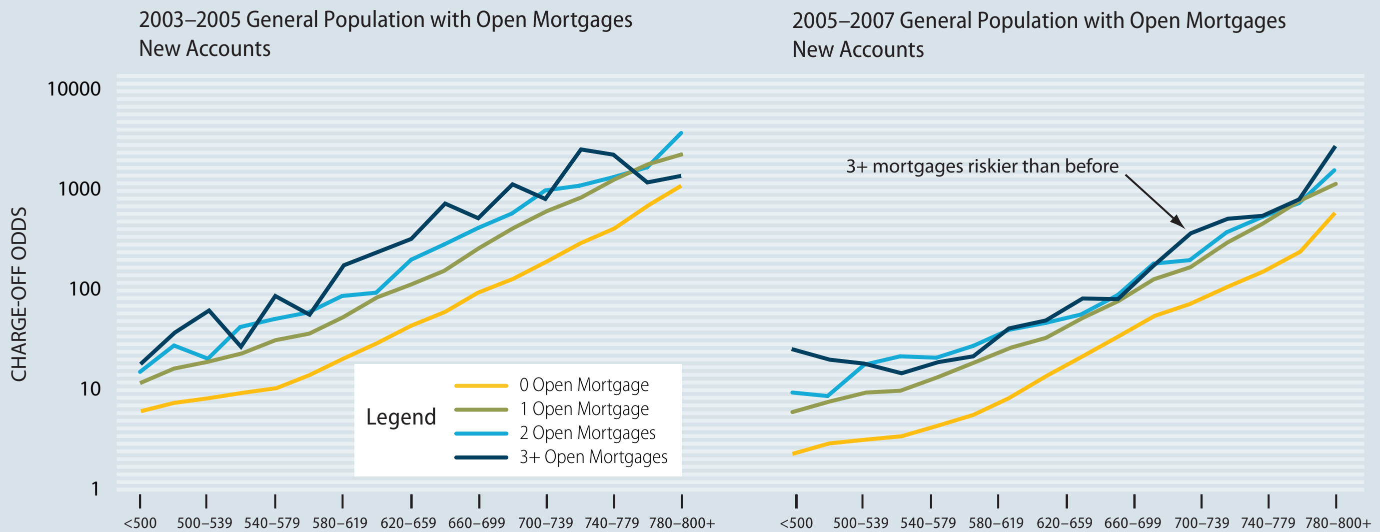
In other words, while risk is increasing across all segments, we see greater increases for those with multiple mortgages. The 3+ mortgage consumers in 2005–2007 are performing at the same risk level as 3+ mortgage consumers in 2003–2005 that score 35–55 points lower. Similarly, odds-to-score relationships for consumers with two mortgages dropped by 45–50 points. By contrast, consumers with only one mortgage showed a 25–30 point difference.

Figure 4: Multiple mortgages still less risky—but risk increasing



In 2003–2005, consumers with 3+ mortgages are lower risk at a given score compared to those with fewer mortgages. In 2005–2007, the 3+ mortgage line drops and converges with those with fewer mortgages; thus, risk is increasing at a given score for this segment.

FICO conducted further analysis to better understand risk score predictors for new mortgage loans in the more recent timeframe. We found that the following segments pose greater risk than before:

- **Shorter time in file**—that is, consumers with newly established credit histories or with a recent build-up of newly opened credit.
- **Little to no prior installment experience**—suggesting a first-time big-ticket purchase, given the lack of auto and home loans on the credit file.
- **Multiple inquiries prior to mortgage opening**—suggesting aggressive credit-seeking behavior.[2]

Knowing these higher-risk credit bureau attributes can help lenders revise underwriting and customer management strategies, as we'll discuss in the "best practices" section of this paper.

» Best practices during uncertainty

Our research on risk trends, combined with today's economic climate, reinforce the need to evaluate and test existing credit policy risk controls.

- Lenders should closely track and **monitor portfolio performance by score**, and make adjustments accordingly.

2 *Inquiries were processed through a de-duplication process, whereby mortgage-related inquiries within 45 days are considered as a single inquiry.*

- Given today's market, it's especially important to **evaluate portfolios by vintage and local economic factors.** If something looks unusual or a vintage isn't performing as expected, it is a red flag for lenders to tighten customer management in those risky areas—and to reevaluate targeting approaches and underwriting criteria.
- More **frequent score refreshes**, even among collateralized products, could identify losses earlier and signal a need to re-evaluate portfolio performance. We recommend at least quarterly account management updates.
- As mentioned earlier, our mortgage validation research identified **specific segments posing greater risk**—those with shorter time in file, multiple prior inquiries and less installment experience. As a result, lenders should review strategies to consider these changing risk patterns and tighten risk controls when appropriate.
- **Stronger risk tools** can also help. Validation results show that the latest release of the FICO® Score, FICO® 8 Score, increased predictive power in higher-risk segments, including credit shoppers and nonprime borrowers.

While credit bureau data and scores are highly predictive, good underwriting and customer management consider a broader view of risk. Risk factors not captured by bureau data, such as fraud or even product terms, can also impact portfolio performance.

To fill in this broader risk picture, lenders can benefit from the growing availability of non-traditional credit data (e.g., debit and phone utility data), as well as from geographic, economic and demographic data sources. Third-party data—and scores based on that data—can help identify changes to consumer risk that lenders might not otherwise be aware of. The FICO® Expansion® Score leverages non-traditional credit data, and when used with the FICO® Score, has been shown to boost risk assessment.

While lenders need to remain risk vigilant, the reality is that they also must be able to grow and pursue new opportunities—often even more difficult in times of uncertainty.

That's why we recommend using risk management tools and techniques that permit lenders to better calculate risk vs. reward—like champion/challenger testing to evaluate and refine strategies before rolling them out to a broad customer base. Lenders can evaluate which products and terms to offer, and which underwriting criteria, scores and external data are most useful in strategies, under varied market conditions for different consumer segments.

Stronger measures of consumer credit capacity can also help lenders identify new opportunities with less risk. FICO® Credit Capacity Index™ is a forward-looking analytic measure that, when combined with FICO® Scores, determines, "For consumers who look equally risky, who can more safely manage additional credit?"

Balancing business growth and risk management, while tricky, certainly continues to be business-critical. Those that do it best are most likely to ride out the market fluctuations and challenges like those we face today.

We will continue to validate FICO® Scores and underlying risk trends, and dig deeper on key scoring topics in future Insights papers. For more information, contact us at 1-888-342–6336 or cbhelpline@fico.com, or subscribe to our Insights white papers at www.fico.com/insights.

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