FICO™

Credit CARD Act: Move Ahead of the Curve

Research shows opportunities for lenders who act quickly and leverage sophisticated scoring and analytic tools

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The Credit CARD Act of 2009 is changing the rules of the game in an industry already reeling from unprecedented delinquency rates. While the full long-term impact is yet to be determined, in the short-term, it is likely to have an adverse impact on profitability. Those who quickly adjust their tactics, taking advantage of the most advanced analytic techniques and practices available, will be most effective at mitigating the impact of the Act.

This paper examines the broader strategic issues of the Act, and identifies opportunities for bankcard lenders to better manage risk using new scoring tools that protect revenue and responsibly grow card portfolios. FICO conducted research to identify short-term areas of opportunity within each of the following goals:

As one of a series of FICO reports on the CARD Act, this paper examines the broader strategic issues, and identifies short-term opportunities for lenders to better manage risk and responsibly grow card portfolios.

Where can I find profitable growth?
As we emerge from the recession, issuers are challenged with identifying areas of growth. More predictive credit risk scores enable you to more confidently find growth in profitable segments while maintaining control over losses.

How can I more accurately assess a consumer's "ability to pay"?
In response to the CARD Act, issuers must consider a customer's ability to pay. Lenders have taken quick action to include self-reported income, income estimators or similar tools to fulfill the immediate legislative requirement. However, to determine repayment risk or set line limits, more sophisticated analytics do a better job of measuring ability to pay.

How can I manage my customers to maximize both profit and customer loyalty?
The CARD Act prevents lenders from re-pricing accounts unless they're 60+ days delinquent with you. We'll show how to better identify and manage those customers before they go delinquent, and improve this identification using newer FICO® Scores.

While the goal of profitable growth is not new, the economic and regulatory landscape has changed. FICO considers these three strategic questions within the context of today's environment and offers specific guidance on how to move quickly to mitigate impact.

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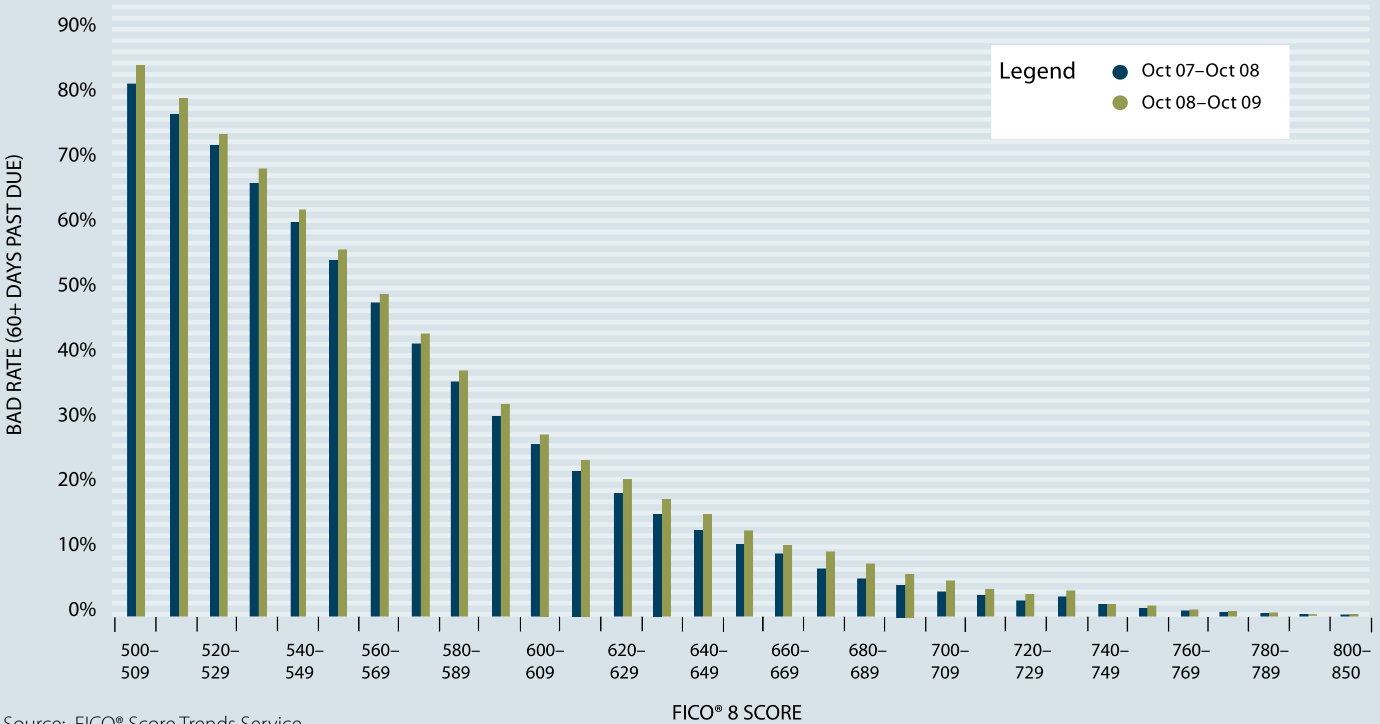
» State of the Market

As we emerge from the financial crisis, the card industry will operate in an environment forever altered. Growth in credit card receivables has stalled as many consumers pay down their balances, and issuers tighten cutoffs and reduce lines in an attempt to control losses.

FICO regularly analyzes FICO® Score performance to help lenders identify industry-wide changes and trends in risk behavior. Figure 1 summarizes the risk trends for existing bankcard accounts from October 2007 through October 2009. The increase in bad rate at a given score reflects the worsening economic conditions, high unemployment, asset deterioration and constrained credit throughout this period. The greater risk in the middle score ranges (600-740) is important to note, since it's the operating range where a majority of a lender's customers would score.

Figure 1: Bankcard bad rates increase with turbulent economy

Bankcard—12-Month Performance—Customer Management—60+/Any Derog



Source: FICO® Score Trends Service

Lenders have responded by significantly tightening lending criteria over the past year for both new and existing accounts. This has included reducing existing credit limits, raising minimum required credit scores and offering lower limits for new accounts. These actions are paying off in more stable delinquency rates, shown in Figure 2.

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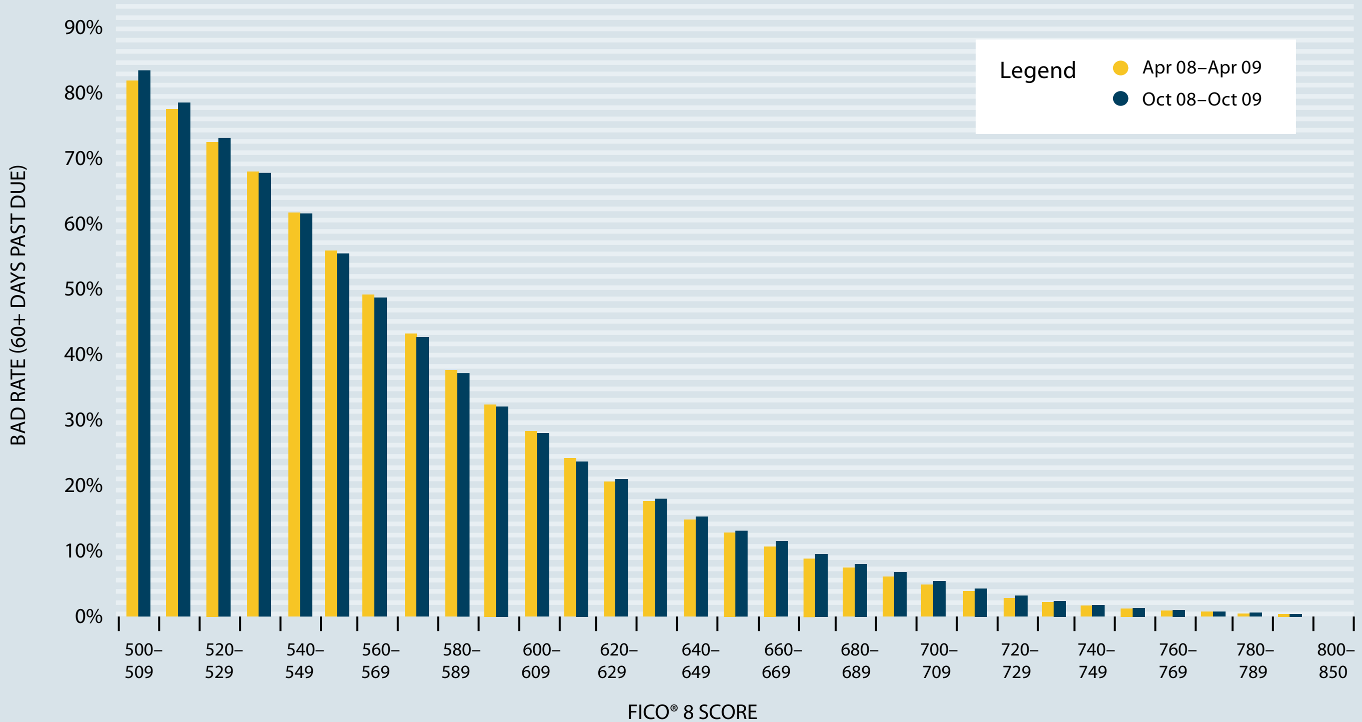
Figure 2, which reflects the latest performance as of October 2009, shows only a minor increase in delinquency rates. While this is welcome news from the perspective of reducing losses, tightened criteria has simultaneously reduced both growth and profits for the card industry.



» Impact of the CARD Act

Credit card companies have always balanced profit versus growth, but are now facing a situation where both are threatened. Growth is constrained by concern over loosening credit standards or further extending lines of credit. Compliance with the CARD Act, which aims to protect consumers and create more responsible lending practices, is further restricting the ability of card issuers to profitably manage their portfolios.

The impact of the CARD Act on profitability has already been felt, as issuers have spent millions of dollars in preparation for the legislation to take effect. This has exacerbated the loss of revenue resulting from lower lines and less spending by consumers during the recent recession. As a result, issuers are focused on recovering revenue shortfalls by adjusting prices, reintroducing annual fees or implementing new fees designed to offset costly customer behavior, such as excessive customer service usage.

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The CARD Act will continue to impact both growth and profitability. Issuers may expand credit lines conservatively as they ascertain the impact of the consumer's ability to prevent overlimit purchases and their own constrained ability to charge fees. Issuers will tend to be more cautious about the amount of new credit they're willing to lend, given their restricted ability to change product terms in the first year. Restrictions on the ability to increase price based on risk will curb lending to higher-risk populations. Product design will be impacted by the necessity to apply payments to the highest interest rate, and clearly disclose card terms and conditions. Forcing issuers to retain low-interest rates for longer periods will alter the profitability of today's products that seek to attract balances through low introductory rates.

Consumers will also be impacted, as issuers adjust practices to conform to the CARD Act. Restricted ability to price for risk will likely increase the price of credit for all consumers, while access to both new credit and expanded lines will be limited by the more restrictive policies in place.

» Industry Response

While it's difficult to predict the long-term response of the card industry to the new economic and regulatory realities, effective product innovation combined with highly effective analytics will be essential to profitability and growth in a post-CARD Act world. Bankcard lenders are likely to respond in some of the following ways:

- Implementing more sophisticated risk assessment tools to identify and "cherry pick" low-risk customers will help bankcard lenders be more competitive as they plan new customer acquisition strategies. Marketing arms of bankcard lenders will have to apply the most accurate risk tools to attract the most desirable customers upfront.
- Appropriate promotions to consumers in high-risk segments may be developed to find profitable growth in the new environment. Instead of a one-size-fits all payment vehicle, what could emerge is an integrated array of retail and payment products across the risk spectrum, allowing customers to seamlessly migrate as their circumstances change.
- Consumers who historically have had difficulty in managing credit might be encouraged to use debit cards, combined with an overdraft facility or secured credit cards, in lieu of traditional credit cards. Reporting usage and performance of these products to the Credit Reporting Agencies may ultimately result in expanded access to credit for these population segments, allowing them to migrate toward traditional credit card offerings as they demonstrate the ability to handle credit responsibly. However, sophisticated analytics must be applied to these overdraft facilities to ensure an appropriate risk/reward equation for the lender.
- Lenders will likely institute more robust credit education programs. Increased transparency of terms and conditions combined with timely financial education will be important components of any new products. In this way, consumers can better understand how their behavior impacts their costs and how they can migrate to lower-risk, lower-cost products. For example, issuers using the FICO® Score View™ Service, which offers consumers free monthly access to their FICO® Scores, have retained better-educated consumers, likely to engage in credit-building activities and remain current on payment obligations.

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- Lenders will look for ways to accurately assess a consumer's capacity to take on additional debt. This is critical to demonstrate responsible lending and compliance with the new regulations, as well as to ensure maximum profitability. Issuers must demonstrate to regulators that they are using industry-standard capabilities that are objective, consistent and provide optimal ability to assess both risk and ability to pay.

Regardless of new products and strategies, issuers will need the most robust, discriminating credit risk scores and analytics. FICO® Score performance during the recent recession provides reassurance that these scores continue to effectively rank-order risk. In addition, FICO has introduced innovative services that anticipate how consumers will react in the future, whether from changing economic conditions (FICO® Economic Impact Service) or from increased debt burden (FICO® Credit Capacity Index™).

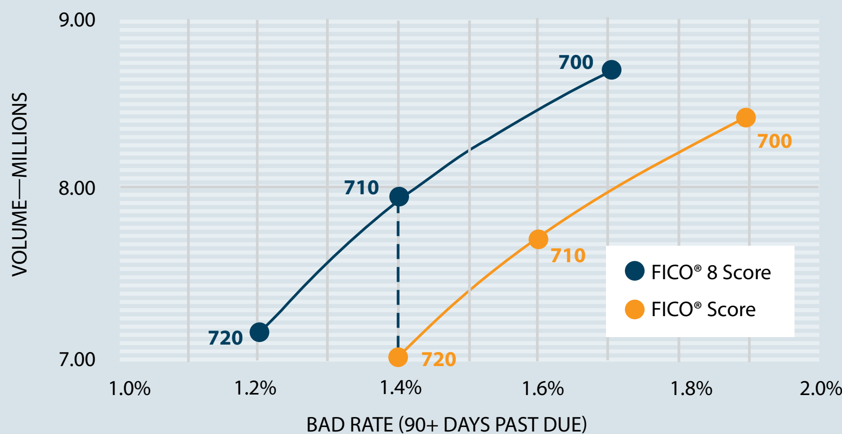
» Where Can I Find Profitable Growth?

Those who are quickest to mobilize during economic recovery and who use the most sophisticated analytics will reap benefits. For card issuers, lessons learned from past recessions offer guidance. Those who strategically shifted from the defensive view of controlling losses to the proactive view of testing new growth strategies were often the winners.

One of the quickest methods to increase market share is to "loosen the credit reins" by altering credit criteria and lowering cutoffs. As always with new acquisitions, it's essential to evaluate the trade-offs between growth and losses, and to ascertain risk levels.

This trade-off has never been more difficult than in today's environment, with consumers still reeling from job loss and constrained credit. The CARD Act has made this challenge even greater. Tighter restrictions on changing card terms during the first year of new accounts make it more critical than ever to identify the right segments to target. It will also be necessary to adjust underwriting policies to offer products and terms that are attractive to customers but still maintain portfolio value over time.

Figure 3: Increase volume while maintaining bad rate
Actively Seeking Credit Population Performance on New Bankcard Accounts



FICO research shows that using more precise scoring tools, such as the FICO® 8 Score, can help card issuers more accurately identify consumers seeking credit who will manage it responsibly. In this study, our research focused on an actively seeking credit population—consumers who opened one or more accounts within the twelve months prior to scoring. We then examined performance of consumers who opened a bankcard within the following six months.

In the Figure 3 example, the lender is using the more conservative 720 FICO® Score cutoff, which would result in a target population of some 7 million consumers who opened a new credit card, and a portfolio bad rate of 1.4% in the 24 months following scoring.

Figure 3 shows the trade-off if the issuer were to increase volume by lowering the cutoff score from 720 to 710, using both the FICO® Score and the FICO® 8 Score.

- Moving from a FICO® Score cutoff of 720 to 710 (orange line) would increase the target population by approximately 700,000 names but would also increase the bad rate of those targeted by 20 basis points (1.6% portfolio bad rate).
- However, using the FICO® 8 Score would allow the issuer to increase volume by an even greater amount while maintaining the existing 1.4% bad rate at a FICO 8 Score cutoff of 710 (highlighted by the dashed line). The FICO 8 Score improves risk prediction through sharper segmentation and refined risk performance classification. This increased performance is particularly notable for the "credit seeker" population in this example.

Figure 4 translates this into potential financial gain, assuming a 1% market share of those who opened a bankcard account, and an average 24-month $250 revenue per good customer and $3,000 average loss per bad customer.

Figure 4: Lower cutoffs *and* sharper scoring tools can dramatically improve profit

	FICO® Score >=720	FICO® Score >= 710	FICO® 8 Score >= 710
Volume Booked	70,010	77,003	79,558
Subsequent Bads	980	1,232	1,114
Subsequent Goods	69,030	75,771	78,444
Revenue from Goods ($MM)	17.3	18.9	19.6
Losses from Bads ($MM)	-2.9	-3.7	-3.3
Profit ($MM)	14.6	15.2	16.3
Profit Improvement (as % of baseline)		4%	12%

As this table shows, lowering the FICO® Score cutoff by 10 points would result in an increased profit improvement of 12%. Although this represents a significant opportunity, many card issuers would remain wary of the potential for increased losses, particularly due to their reduced flexibility to adjust terms in the first year.

This problem is alleviated by using the FICO® 8 Score instead. At a cutoff of 710, the FICO 8 Score strategy would "swap in" a more profitable consumer segment (more "goods" and less "bads" booked, as shown in the graphic) compared to the prior FICO® Score. As a result, the FICO 8 Score would allow the issuer to reduce the cutoff to 710 and increase its volume at the same bad rate, resulting in an additional $2.6 million in profit.

This example illustrates the advantages of using the FICO® 8 Score in account growth strategies. By quickly implementing the more predictive risk score and testing new cutoff strategies today, lenders can gain a significant jump on the competition.

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» How Can I Assess a Consumer's "Ability to Pay"?

The CARD Act requires issuers to consider a consumer's ability to make the required payments for a new account or increased credit limit. The Act specifies that this must include a review of consumer's income or assets, as well as their current obligations.

Self-reported income could be used, but the accuracy of this information is unknown, and is extremely costly and time-consuming to verify. Similarly, measures of debt ratio, obtained either from the consumer or the credit bureau, may not be sufficient to use alone. This is because they're based on existing debt and don't consider the risk impact of the additional debt of the new card or line. Lenders need a more precise measure that considers how the new debt will impact a consumer's ability to pay as agreed.

Understanding the impact of additional credit on future delinquency rates is not only a requirement of the Act, it's essential to overall portfolio profitability. Many issuers have developed finely honed models that predict the profit of targeted accounts over a particular time horizon. Accurate estimates of delinquency rates are a critical component of these projections. Setting the credit line too high can cause dollar losses to double or even triple.

In the past, issuers have used pricing changes to compensate for these changes in delinquency. However, since the CARD Act now restricts an issuer's ability to change pricing during the first year, inaccurate estimates of delinquency could cause overall profitability projections to quickly move from positive to negative.

The ability to more accurately assess how consumer credit capacity impacts future delinquency will allow issuers to set initial lines with more confidence. Better assessment of a consumer's capacity can also help issuers avoid setting lines too low, leading to missed revenue opportunities or customer attrition.

Recent research shows that using a bureau-based capacity measure like the FICO® Credit Capacity Index™ (FICO CCI) can more effectively help lenders determine a consumer's ability to pay. FICO CCI successfully separates consumer segments capable of handling additional credit from those for whom the new debt would result in delinquency. It is an anticipatory risk measure that rank-orders consumers based on their ability to safely manage new or increased debt on top of existing debt loads.

Figure 5 shows 24-month performance of new bankcard accounts within the same risk band (690-714 FICO® Score range). Each line represents accounts with a similar value of FICO® CCI (low, medium or high) at the time of origination. The points on the horizontal access represent accounts with varying levels of increase in revolving balance over the subsequent 12-month period. As expected, the larger the increase in revolving debt over time, the higher the bad rate.

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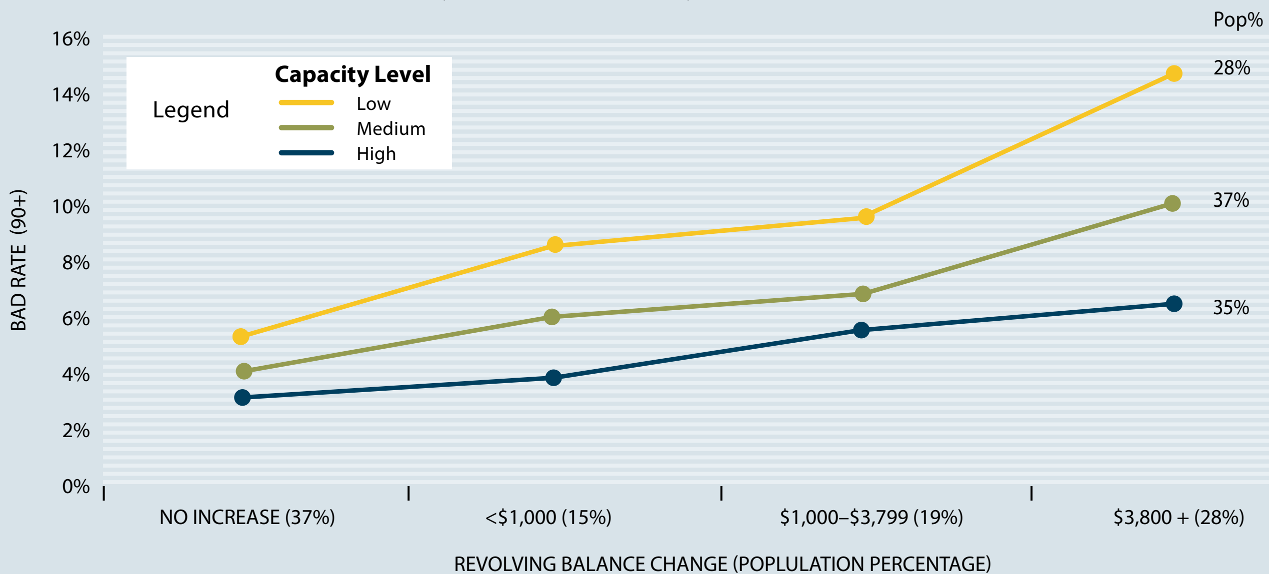
Figure 5: Identify consumers' ability to handle higher debt burdens

New Bankcards—FICO® Score 690–714 by FICO® Credit Capacity Index™



What's more interesting is that the *change* in bad rate differs dramatically depending upon capacity level. The bad rate of the high-capacity group (those identified as being able to more safely take on incremental debt) increases from 3% to 6%, while the bad rate of the low-capacity group essentially triples from 5% to 14%.

Lenders who can identify consumers with similar risk profiles but different levels of credit capacity can more effectively fine-tune account management strategies. They might offer smaller initial lines to consumers with lower capacity. They can also further minimize potential losses from delinquent balances by reacting more quickly to early-warning signs. For example, tighter authorization policies and tougher early collection efforts can be used to address frequent overlimit attempts or missed payments.

On the positive side, lenders can maximize revenue by setting higher initial lines for consumers who can handle more capacity. Over time, as these consumers demonstrate the need for additional credit, lenders can use the *current* value of their FICO® CCI, combined with their most recent FICO® Score, to safely increase credit limits.

The research findings show that FICO CCI serves as a practical tool for lenders to more accurately make line limits and originations decisions. However, card issuers may be using self-reported income or an income estimator to meet the requirements of Regulation Z. The question is: How does FICO CCI compare with income as a predictive measure of a consumer's ability to pay?

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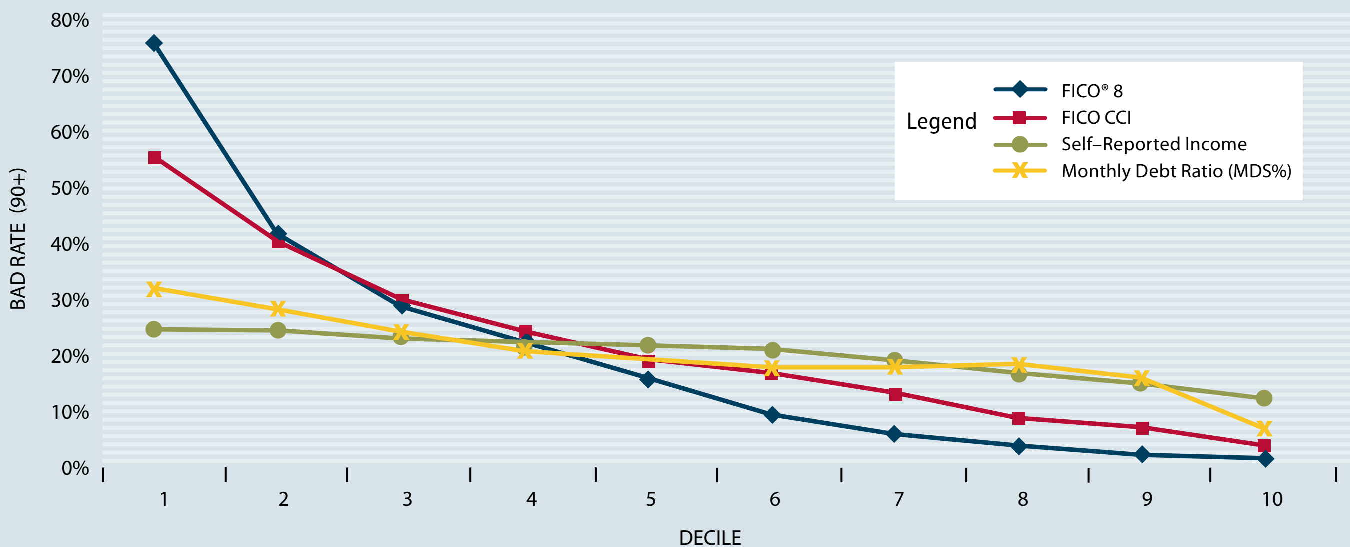
FICO conducted research on a large pool of bankcard accounts to determine the accuracy of FICO® CCI in predicting future risk of payment default compared to several income measures: self-reported income and a generated monthly debt service ratio (MDS). Figure 6 charts future bad rates for the FICO® 8 Score, FICO CCI, self-reported income and the monthly debt service ratio. Each measure is ranked from the "worst" (expected highest risk) decile to the "best" (expected lowest risk) decile as follows:

- FICO® Score—lowest FICO® Score range in decile 1 up to highest FICO® Score range in decile 10
- FICO® CCI—lowest CCI in decile 1; highest CCI in decile 10
- Income—lowest income in decile 1; highest income in decile 10
- MDS%—highest MDS% in decile 1; lowest MDS% in decile 10

Figure 6: FICO® 8 and FICO® CCI more accurately predict ability to pay
Decile Ranking—New and Existing Accounts—General Performance (90+)

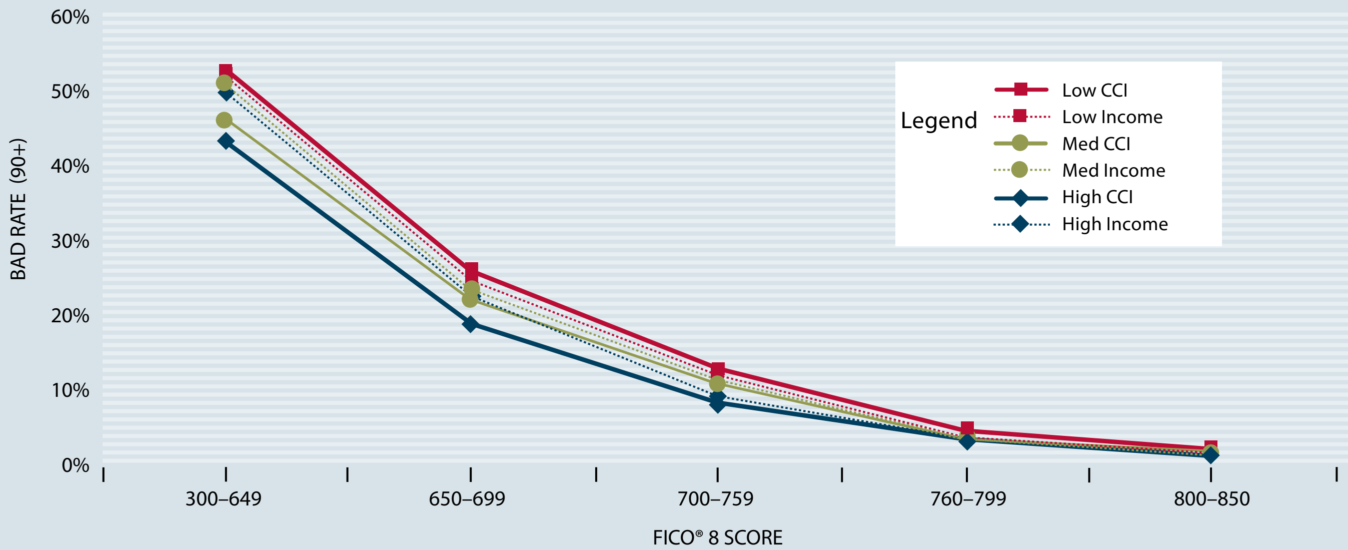


FICO® 8 Score and FICO® CCI were found to be the most predictive of future bad behavior. We see that those in the highest-risk deciles did indeed result in higher bad rates, while those in the lowest-risk deciles resulted in lower bad rates. By contrast, self-reported income and monthly debt service ratio separated future risk less effectively.

Since most lenders will use the income measures in combination with other criteria, the study further investigated the ability of FICO® CCI and income to differentiate risk for given FICO® 8 Score ranges.

Figure 7: FICO® CCI is more predictive within FICO® 8 score bands

FICO® 8 by Estimated Income & CCI—New and Existing Accounts—General Performance (90+)



In Figure 7, FICO® CCI is shown to more effectively isolate the least risky (solid blue line) and riskiest (solid red line) subpopulations compared to the income estimator (dotted lines), that shows little variance in bad rate by FICO® Score bands.

While lenders receive value from using self-reported income or income estimators to meet CARD requirements, these measures do not provide nearly the predictive value as FICO® CCI in determining which consumers can more safely take on incremental debt.

» How Can I Manage Customers to Maximize Both Profit and Loyalty?

New provisions of the CARD Act will also impact a card issuer's ability to manage profitability for accounts that have been on the books for 12 months or longer, particularly in the area of re-pricing. Specifically, the CARD Act will prohibit risk-based interest rate changes unless the account is 60+ days past due.

Most issuers agree that an account 60+ days past due is already well on its way to charge-off and, thus, action needs to be taken much sooner. While the new laws will restrict pricing changes for accounts not yet 60+ days delinquent, other account management actions can still be used to control losses and maximize revenue.

Lenders require strategies that foster loyalty and usage for low-risk customers, while restricting delinquent balances for high-risk customers. Figure 8 shows potential strategies in authorizations, collections, line management and cross-selling for managing these two groups.

Figure 8: Choosing the right strategy according to risk

	Customers likely to remain current	Customers likely to become 2+ cycles delinquent
Overall Objective	Find opportunities to increase loyalty through proactive action	Act more aggressively to take restrictive action and minimize risk
Authorizations	Allow cushion and consider line increases Provide financial education	Restrict overlimit purchases and consider freezing account
Collections	Provide financial education	Treat early and aggressively
Line Management	Provide prudent increases	Decrease to control delinquent balances
Cross-Sell	Offer other products to provide cushion during times of financial hardship	"Encourage" termination

For low-risk customers, there are opportunities to increase loyalty by proactively reaching out in a positive way. For example, if a low-risk customer makes a late payment, the issuer might offer to adjust the due date to coincide with a consistent date on which the consumer gets paid. Similarly, frequent overlimit attempts by this group might be rewarded by an increased credit line.

On the other hand, for a higher-risk customer who misses an initial payment, the issuer will want to act more aggressively in early collections—specifically, not permitting overlimit purchases and contacting the customer about the missed payment more quickly and forcefully. The issuer might consider reducing the customer's existing line or terminating the account.

Choosing the right action for the right group of accounts can go a long way toward increasing profit and reducing losses—but getting these actions wrong can have disastrous effects. Treating good customers harshly risks losing them to the competition.

Therefore, it's essential to use the best tools available to identify accounts most imminently at risk while it's still early enough to reduce losses, as well as minimize negative actions on good accounts. Behavior scores (as found in the FICO® TRIAD® Customer Manager) continue to be the strongest single predictor of risk. However, issuers have traditionally found additional value in understanding the broader picture of how a consumer is handling his/her credit obligations with other lenders, as reflected in the FICO® Score.

While the Act will restrict pricing changes based *solely* on performance with other lenders, the combination of internal and external scores still provides the most predictive measure of risk to drive account management actions, especially on accounts that have historically performed well with the issuer.

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To better quantify the value of using combined scores for early identification of accounts at risk of going bad, we analyzed the predictive value of the FICO® 8 Score combined with behavior score. Leveraging a pooled sample of credit card accounts, we targeted our analysis to a "low-risk" account segment that had not missed a credit card payment in the 24 months prior to scoring, and then measured performance over the six months following scoring (bad definition of 60+ days delinquent).

Figure 9: Better identify accounts most imminently at risk of future delinquency

BEHAVIOR SCORE	FICO® 8 SCORE						
	Low–619	620-659	660-679	680-699	700-719	720-High	TOTAL BAD RATE
Low–679	19.4%	10.9%	8.6%	7.4%	6.0%	3.5%	11.5%
680–699	13.5%	6.9%	5.2%	4.4%	3.3%	1.8%	5.4%
700–709	10.2%	4.7%	3.5%	2.8%	2.3%	1.1%	2.9%
710–719	9.4%	4.2%	2.8%	2.2%	1.8%	1.0%	2.1%
720–729	7.1%	3.2%	2.0%	1.5%	1.4%	0.6%	1.3%
730–739	5.3%	2.0%	1.4%	1.2%	0.9%	0.4%	0.7%
740–749	4.4%	1.6%	0.9%	0.8%	0.6%	0.3%	0.5%
750–High	2.8%	1.0%	0.6%	0.5%	0.3%	0.1%	0.2%
TOTAL BAD RATE	14.2%	6.5%	4.2%	3.0%	2.0%	0.5%	2.5%

Figure 9 shows how the FICO® 8 Score can be used with a behavior score to more effectively target accounts most likely to become delinquent in this "low-risk" segment. For example, while the bad rate of all accounts scoring below a behavior score of 680 is 11.5%, the FICO 8 Score can distinguish accounts within that range with bad rates ranging from 19.4% to 3.5%.

Let's assume a lender is targeting a group of up-to-date accounts for the harsher treatment described above *as soon as* a payment is missed. Since these actions could cause unwanted attrition, it's important to identify accounts most likely to go bad, while minimizing the number of good accounts affected. Assume the lender targets accounts where the expected bad rate is greater than 10%. Using only a behavior score, this would target accounts with a behavior score less than 680 (outlined in red), while the dual-score strategy would target the accounts highlighted in orange.

The financial benefit of using a dual-score strategy, with either the FICO® Score or the more predictive FICO® 8 Score, is shown in Figure 10. These numbers assume a portfolio of 1 million accounts, an average "saved balance" of $2500 for the bad accounts (assuming the lender can't save the entire existing balance) and an average loss in revenue of $350 for good accounts.

Figure 10: Dual-score strategy delivers significant financial benefits

	Behavior Score Alone	Behavior & FICO® Scores	Behavior & FICO® 8 Scores
Bads Targeted (000's)	6.3	6.4	6.3
Total Volume Impacted (000's)	55.2	48.2	45.2
Lost Revenue from Goods ($MM)	17.1	14.6	13.6
Saved Losses from Bads ($MM)	15.9	16.1	15.9
Profit ($MM)	(-$1.2)	$1.4	2.3

All strategies target approximately 6,000 bad accounts, but the strategy using behavior score alone affects too many good accounts, resulting in negative profit. The dual-score strategy using the FICO® Score is able to identify the same number of bad accounts at a lower overall volume, thereby impacting fewer good accounts and resulting in higher profit. Using the more predictive FICO 8 Score reduces the targeted volume even further, significantly improving potential profit.

In addition to identifying future delinquencies, the dual-score strategy can also help detect currently delinquent accounts that might warrant "softer" account management actions that encourage loyalty and improve retention of profitable customers. In the Figure 9 example, this might include accounts scoring less than 680 on the behavior score, but higher than 720 on the FICO® 8 Score.

In a post-CARD world, where customer management actions are more restricted, timely identification of risky accounts is imperative. Earlier FICO research, highlighted in the Insights paper ***"Scoring Your Customers: How Often Is Often Enough?,"*** showed that in these times of quickly changing risk profiles, a significant percentage of scores increase or decrease by 20 points from month to month. Therefore, it is essential to obtain fresh scores on a monthly basis for best results.

In the wake of the limited re-pricing actions imposed by the CARD Act, issuers will want to use both internal and external information, refreshed monthly, to accurately predict future customer behavior. Issuers can begin testing these potential strategies immediately to determine which account management strategies best meet their needs.

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» Conclusion

The CARD Act of 2009 will have a major impact on the credit card industry and the customers it serves. Since the Act limits opportunities to increase pricing and restricts the use of various fees, issuers will need to work harder than ever to achieve the same level of profitability.

The rules have changed. Strategies for acquiring and managing customers now require the most sophisticated analytics to assist at every stage of the bankcard customer lifecycle. The most successful card issuers will act quickly to test new strategies, employ the sharpest risk tools available, and move beyond simply fulfilling the letter of the law to a strategic approach for portfolio growth and profitability.

Learn more:

- Read the Insights paper: ***How Profitable Will Your Cards Be After the CARD Act?***
- Read the Insights paper: ***Build Your Action Plan for the Credit CARD Act***
- Get information on FICO's program for Reengineering Card Profitability at ***www.fico.com/cards***

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