



A Cautious Outlook For Household Credit Demand

BY ANNETTA CORTEZ AND GAURAV GUPTA

As retail banks gear up for 2011, they are facing critical questions about consumer credit demand. While the lingering serious challenges with mortgages and credit cards are well known, institutions still have a pressing need for earnings growth, if it can be found. It seems unlikely that household borrowing will begin to broadly climb in tandem with a reviving economy.

Instead of a strong, widespread expansion, a scenario more hospitable to product push strategies, it will be an uneven market with scattered pockets of demand and lingering pockets of risk, a scenario requiring precise targeting and a far stronger relationship context.

Along with carefully considering the shape and scope of household credit demand, retail banks will have to adjust the marketing and sales context, both to reflect the importance of remaining viable borrowers, and also to provide the advisory expertise and reassurance that people are hungry for in the post-crisis economy.

Looking ahead, we believe that U.S. households will generally continue to de-leverage, perhaps through 2012. This includes working down revolving and installment debt, rebuilding cash cushions, and for many, working through defaults. Employment remains a challenge; the housing market remains a challenge.

Even when these obstacles begin to noticeably subside, perhaps two or three years from now, the retail credit market still will look different. Increasing numbers of Baby Boom households are nearing retirement and won't return to the peak borrowing and spending patterns of recent years. Credit demand likely won't revive to prior levels.

The situation calls for a fundamental re-thinking of retail credit strategies. Instead of strictly pushing credit products through separate lines of business, winning banks will shift the emphasis from new account acquisition to relationship expansion among established customers. This will require a far deeper analytical understanding of customer needs and risk profiles; an improved ability to drive information to the point of sale; and a different sales orientation and skill set.

Looking at short-term growth potential, one area of at least modest opportunity is home equity lending. As of the spring of 2010, households still had more than \$6 trillion of unencumbered equity, and this remains a convenient and advantageous form of borrowing. But to put it in perspective, home equity loan originations still will fall 70% short of the peak in 2005, and mortgage originations will fall 40% short. Meanwhile, we could see further absolute declines in credit card borrowing and student loans.

The upshot is intense competition for a reduced volume of household credit demand. It is a lopsided market, with severe skews in local housing, employment, and overall household financial stability. Winning banks will need superior skills in targeting, relationship management, risk-adjusted pricing and underwriting.

A CHANGED MARKET

There is no question that U.S. households are de-leveraging. Compared with a more than \$1 trillion expansion in each of the peak years of 2004 to 2006, households reduced their debt load by more than \$200 billion in 2009, and the contraction was continuing at an even faster annualized pace in the early part of 2010. Both for reasons of attitude and of necessity, we see this trend continuing, as supported by the following:

Jobs. Looking at the job picture, the national unemployment rate as of mid-2010 was just under 10%, with about 15 million people looking for work. This compares with a 5.5% unemployment rate three years earlier, in 2008. We are not in the business of econometric forecasting, but don't yet see evidence of a strong resurgence in hiring.

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Debt. In turn, the job situation certainly has a bearing on the ability of households to manage their debt burdens. Currently, the charge-off rate on mortgages is running at 10 times the historical average. And the current charge-off rate on credit cards is double what was seen in the bellwether years of 2007 and 2008. Given continuing high unemployment, we do not see quick improvements in credit quality.

Housing. A further complication is sinking housing values. At the end of 2009 nearly one of every four borrowers was upside down on the mortgage, owing more than the market value of the dwelling (the comparable ratio was 10% in 2005). Nationwide, there has been a 22 percentage-point drop in home equity value relative to household real estate holdings — from 60% in 2005 to 38% in early 2010. It's an illiquid market where many households can't find buyers on suitable terms; aren't eligible to refinance; and often are struggling just to hang on.

Based on these three factors alone — jobs, debt burden and housing — it appears entirely realistic to plan for a continuing tight retail credit market in 2011, easily extending into 2012. Banks will need a different compass to navigate

these waters, guided much more by customer relationships than by product dynamics.

From a risk perspective, there are fewer tiers of the retail market that banks can profitably serve. Along with underwriting challenges, banks and credit card issuers are dealing with new regulations that will have the effect of limiting fee revenues, increasing underlying costs for lenders, and limiting lender flexibility. Of necessity, institutions will gravitate toward the middle and upper credit tiers, where there will be intense competition for a smaller pool of business.

RELATIONSHIP LENDING

With fewer new customers coming through the door and a slackening of demand among established customers, the question is how to make the most of each opportunity. Obviously, a huge priority is increasing profitable penetration among the established customer base. And to the greatest extent possible, banks will want to expand new customer relationships to include multiple products.

There are several advantages to relationship expansion through cross-sell:

- It can **dramatically improve customer relationship profitability**, depending on the products involved. A retail relationship that includes a home equity loan, for example, typically has three to four times the average profitability.
- It is **more cost effective**, compared with the effort required to sell each product separately, or to establish entirely new relationships.
- It provides a **richer context for competitive and bundled pricing strategies**. On a selective basis, for example, there are opportunities to improve sales by offering attractive rates contingent on a multi-product credit bundle. Also, product bundles are more amenable to segment variations, some of which can actually fetch premium rates based on better targeting of price, promotion and features.
- It provides a **richer context for underwriting**, line management and collections. Rich customer information can be gleaned from in-depth relationships, but such insights have not been used fully in credit risk management. For example, we believe that there are many unexplored opportunities to take advantage of in-house customer information to extend credit where it otherwise might not seem feasible.
- It contributes to **relationship longevity**, which in turn can significantly increase the profitability of lending products. Customers who have multi-product relationships with their bank are far less prone to switch providers.

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- There is evidence that relationship borrowers are more conscientious about keeping up with their payments when they are dealing with a single institution.

Unlike in traditional cross-selling, which tends to push products to large groups of customers who may have little in common, progressive strategies will hinge on a robust understanding of customer needs and behaviors, particularly as observed in patterns among major customer groups, and a segment-based understanding of how value is created across product lines. Such insights will provide critical guidance in targeting and presenting offers; in managing credit risk; and providing effective service.

In previous years, a generally buoyant market provided an atmosphere of strong product demand that lessened the economic rationale for in-depth relationship strategies, which do entail their own costs and complexities. In our view, a shifting market has settled the question of whether banks should reconsider cross-sell. They should. If banks are to redouble their efforts in this direction, however, then they will need quantum improvements in their strategies and skills. One essential strategy is taking far greater advantage of the primary payments account.

The principal household checking account, for example, offers valuable insights into customer behaviors and needs, plus it provides more customer touch points. One clear retail banking priority is to capture the primary payments account and nurture the relationship-building opportunities that go with it, not only initially, but over the life of the relationship.

Some regional banks also may want to put more emphasis on the credit card. In conjunction with the checking account, it provides a fuller payment view, and by itself provides a window into customer behaviors and needs.

The credit card can provide rich monthly transaction information that provides strong guidance in customer segmentation for use across all products. It also can provide a valuable vantage point in understanding and tracking the credit risk of individuals and households. Some regional banks are thinking more seriously about card expansion at a time when the biggest issuers currently are on the defensive with delinquencies, reputational issues and new regulations.

Another priority is precision targeting. As the bank improves its analytical understanding of customers, then it can begin to refine offers for major customer groups, and focus

on selectively presenting various offers where they will do the most good. This level of marketing detail considers variations in regional economies, housing conditions and competitive intensity, as well as variations in household demand and risk profiles.

In many cases, banks also have opportunities to improve their anticipatory sales strategies, based on an understanding of customer stage of life, major life events, and an analytical understanding of likely cross-sell progressions from one product family to another. Along with being financially constructive, this sort of proactive outreach brings authenticity to a relationship orientation.

To fully capitalize on these initiatives, retail banks will need to improve their credit pricing skills. In the coming battle for market share, lenders will face the challenge of skillfully using rates to attract new business while also assuring that they are doing a good job of protecting risk-adjusted returns. With new regulations limiting fee revenues and flexibility in account management, the importance of striking the right pricing balance up front — at the onset of new relationships — has never been greater.

APPROACH TO THE MARKET

In drawing up plans for next year, it is important to factor customer attitudes into the list of considerations. Many consumers are not only wounded but distrustful.

There is a strong perception that banks, especially the biggest ones, actively contributed to the housing and debt crisis by knowingly helping people to get in over their heads. Adding fuel to the fire, lawmakers and regulators have gone after credit card fees, checking overdraft fees, and more recently debit card fees, in each case with the strong implication that banks have been taking advantage of customers.

Rebuilding trust, therefore, has to be a priority over the next few years. Households genuinely need the kind of guidance and service that banks can provide. Our research, for example, indicates that perhaps more than half of U.S. households with checking accounts are living paycheck to paycheck. No wonder they are wary about the next financial trap that might be lurking around the corner.

In turn, banks will need to review the tone and substance of branch service. Especially with high-value transactions, such as whole mortgages and home equity loans, customer

face time can't lapse into forms and pencil-pushing. The advisory aspect of front line sales interaction is much more important than before, with implications for staff performance and attendant needs for training, coaching and sales management.

One management implication is the probable need for greater centralization of key lending functions, linked to a much stronger analytical capability. This is in line with management progressions in the deposit business, where regional teams are placing greater emphasis on marketing and sales, and central teams are handling pricing strategies and tactics.

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Underwriting is also a changed exercise, especially given the growing willingness of distressed borrowers to simply walk away from their obligations. That's one more argument for a strong central analytical team that can help to limit exposure on the front end through advanced screening, and also help to limit losses on the back end through proactive identification of emerging borrower distress.

There is also the question of how to drive centrally generated customer analytics to the individual branch. While individual product silos will still be a major operational reality behind the scenes, the branch representative needs to be able to present something more to the customer.

From an information perspective, a comprehensive sales approach will require a fuller view of the total customer relationship at the point of sale. Additional needs include targeting information; guidance in conversational prompts; and enhanced sales training that includes more of a financial management component, suitable for identifying deeper customer needs and assisting people in making larger decisions. Some banks are already solving the management and operational problems in making this happen. Others have a long way to go and they will be at an increasing competitive disadvantage.

Mindful of past failures with mega-database projects under the heading of customer relationship management, or CRM, retail banks will need to identify priority areas where advanced information will really help, such as in promoting high-margin home equity lending, or improving risk-adjusted pricing, and build out required central capabilities in

conjunction with a solid business case for improved branch performance.

THE CASE FOR CHANGE

From an organizational perspective, executive leaders will be dealing with coordination and incentive issues. Product teams will need to collaborate among themselves and with the branch team if the bank is to succeed with centrally-designed relationship-focused cross-sell offers. Also, individual product silos typically have their own performance incentive programs that discourage feature or pricing tradeoffs that, while successful with customers, might diminish the profitability of an individual product line. There also will be a learning curve in re-fitting information systems and working through the complexity of the underlying analytics.

Especially over the last decade, retail banks have built up a lot of new branch distribution capacity, and that effort seemed well-justified during an era of high product sales volume. Now that capacity faces a potential extended era of under-utilization.

Facing fewer opportunities to generate new accounts with traditional mass-market product promotions, growth-hungry retail banks will need to do a better job of expanding the amount of business done with established customers. In turn, this type of expansion can only be accomplished within a robust relationship context.

There will be a distinct revenue advantage for banks that successfully make this transition, providing a powerful business case for fleshing out relationship strategies. By contrast, banks that simply try to streamline operations, and do a more efficient job of pushing individual loan products, will be at increasing risk of losing market share.

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