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Not Too Early for Lenders to Regroup and Think Ahead

Banks are beginning to demand a variety of new solutions that will bring them through the lending downturn and position them for the eventual upswing.

As the subprime lending crisis put an abrupt stop to the lending boom, banks were reminded that all good things come to an end. For industry veterans, however, ups and downs in the lending arena (though perhaps not to the recent extremes) are nothing new. But the industry often has a short memory -- when things are going well, it's hard to plan for the cyclical downturns of the lending business.

Now, of course, the latest phase of high-flying mortgage dealing has crashed back to earth. As a result, banks and other lenders are taking pause and regrouping. Yes, they must clean up the mess left by the credit crunch. But, after all, for every down cycle, there's a recovery, too, and lenders want to make sure they're ready with the right strategies and technology for the next upswing in the market.

According to Ira Sleasman, SVP with Las Vegas-based Bank of Nevada, part of Western Alliance Bancorp ($5 billion in assets), the industry is getting back to basics. "You're seeing greater qualification for applicants in terms of things such as their documented income and debt levels," he says. "We're approving loans that conform to prudent credit policy. So it's becoming a more conventional market, and so are the products."

The American Bankers Association's Doug Johnson, VP of risk management policy with the Washington-based organization, also points to a movement back to more conservative lending practices, as is the case whenever a down cycle occurs. "Banks are looking at their credit portfolios and making more-conservative credit decisions," he says. "That's pretty standard in this situation. It has been a while since we had a true business cycle. But that's the nature of the business, and it's a standard business cycle we're in. Banks are looking at their business and credit models and determining if they need to change the parameters of how they give credit. It's happening now, and it's having an effect."

One of the ways in which this change is manifesting itself is in banks' renewed interest in the tried-and-true five 'C's of credit: character, capacity, capital, collateral and conditions, according to Clark Abraham, marketing director with Cary, N.C.-based SAS. "These represent the foundation of credit granting, and I think the industry moved away from the basics and relied too much on their models. For example, you might have a model that looks for [a history of] bad loans because that's the easiest thing [to identify]. But that doesn't take into account the fact that a borrower might pay his bills in full and never defaults. Lenders have to start looking at the nuances of individuals."

Closing the Underwriting Gap

As a result of this realization, Abraham, like the ABA's Johnson, says banks are beginning to recalibrate their credit models. But, he says, banks must go further, understanding that there's an underwriting gap. "There's a difference between the underwriting decisioning model and the borrower, business and market reality," Abraham contends. "The gap is between the ideal and the reality. Lenders need to start narrowing this gap with accurate loss prediction and less reliance on past prediction."

Abraham maintains that this gap exists in the data, model factors, sampling and model construction. He suggests that banks look to alternative forms of credit data, that models be designed to look farther into the future than they currently do, and that a hybrid model of sampling and model construction in which broader

parameters are used to understand the customer more completely be adopted. "Lenders have to take control back from their models," he insists. "You need a hybrid model that uses sound principles and science."

Everyone agrees that banks and other lenders will need to be more careful going forward when evaluating potential borrowers, certainly in the subprime area, but also in the prime market. As an extension of this shift, says Robert Phillips, chief science officer and VP, research and development, with San Bruno, Calif.-based Nomis Solutions, since the credit crisis came to a head he has seen more investment in his company's price optimization solutions. To Phillips, however, banks' push to price products more strategically has a deeper meaning.

"What this says is that banks are looking beyond the world of price optimization and they're hungering to really understand their customers," Phillips explains. "They haven't done a good job of this in the past. So rather than just advertising better rates, there's a real desire to know the customers better. The winners will be those who can understand their clients at a deeper level. They'll want to take a lifecycle view of their customers, looking across products and time from the initial acquisition decision."

Integrating Data for a Holistic View

It is this kind of approach that enhances banks' relationships with their customers, says Kevin Guenthner, CIO with Billings, Mont.-based First Interstate Bank ($6 billion in assets). "Our job is to integrate [data]," he says. "We have many platforms and technologies that deal with relationships. We take data from various channels and get a better view of the customer to create products that fit the relationship."

Using the wealth of customer data the right way is the key to relationship banking, asserts Joel Pruis, director of advisory services with Carmel, Ind.-based Baker Hill. "Banks own a huge amount of data. They are doing more analysis, but the challenge is gaining a global perspective of the client and the relationship," he relates. "They want to be able to see the relationship in one place. But it's an ideal that's yet to be realized." Noting the siloed nature of banks' systems, Pruis acknowledges that "Unifying all these accounting systems becomes a nightmare."

Baker Hill is attempting to address this problem with its Portfolio Risk Advisor product, which, Pruis says, is designed to help the process along by creating a more unified view of the customer. The solution brings in data from diverse areas of the enterprise, such as the credit card and small business units, so the bank can gain a holistic view of the relationship, he says. "We run rules against the data and bring it to the attention of the financial institution so it can intervene at the appropriate time [in the event of a loan going bad]."

Looking on the bright side, the credit crisis was a good thing in that it "highlighted inadequacies of the monitoring of [banks'] portfolios," adds Pruis. "As they assess what happened, lenders are having a lot of 'Aha!' moments. Look at the positive aspect. How well are you treating your customers? At these times, we can become so focused on the cleanup that we sometimes ignore the ones who are doing well. The crisis has reinvigorated the need for a global view of the clients -- not just their balances, but overall activity and behavior."

This type of combined lending platform is something that Fiserv's customers have been requesting, says Jack Pence, VP, strategic alliances, with the Brookfield, Wis.-based company, who notes that the vendor currently offers a combined servicing platform that services various consumer loans and is developing a combined origination platform, as well. "The key to this," Pence explains, "will be having a decision engine-centric design where you can easily change products and pricing as needed and change the workflows as operations, regulations and legislation are modified."

The Flexibility to Recover

This movement toward adaptable models and technologies is one of the keys to thriving in the recovery phase and beyond, according to SAS's Abraham. "The technology to give banks flexibility to work around data deficiencies will provide huge competitive advantage," he says.

Abraham is a believer in the use of alternative credit data, such as utility bill payment history, in gauging the creditworthiness of borrowers. After all, he contends, the subprime market won't disappear. "The alternative area for consumers is a growing, untapped market," he says. "In some geographies, there is a lack of reliable data. By using a hybrid approach where you start with rules and collect other data on these segments, you do the data development. This is adaptive credit scoring."

Eric Lindeen, marketing director with Bozeman, Mont.-based Zoot Enterprises, a company that provides credit-decisioning and other lending solutions, says lenders cannot continue to take a one-size-fits-all approach to how they lend credit in different markets. "If an institution has coverage in Florida and Montana, the economies in these states are very different," he notes. "So financial institutions now have to look at their overall territory to make credit policies that are in line with what they're seeing in other parts of the country. The geography issue hasn't really been considered much since the downturn."

First Interstate Bank offers a case in point. The financial institution serves Montana and Wyoming -- areas that haven't quite felt the sting of the lending mess as badly as other regions. According to John Pannell, VP, risk/finance, in First Interstate Bank's credit card division, "We just haven't seen the same economic crisis as the rest of the country in our geography."

No matter where in the country a lender operates, however, it still will face many of the same challenges around granting credit, only in a more risk-aware climate. As such, decisioning and analytics technology, for example, will continue to be at the forefront of First Interstate's lending practice, according to the bank's Guenthner, who notes that the institution is a Zoot client.

"If you look historically at what the industry has done, decisioning an applicant was a very burdensome and judgment-laden process. With analytics, we're now able to compare the person to our rules-based lending system and decide if we should issue credit to him," Guenthner explains. "We want to make sure people match our criteria for lending. We use prescreening capabilities and go through our existing accounts to identify who meets our criteria."

Decisioning Tech Key to Lending Success

According to Walter O'Haire, a senior analyst with Boston-based Celent, the quality and speed of a lender's decisioning technology will make or break it in the eyes of customers. "The one point in time where it is crucial to have good technology is at the decisioning point," he asserts. "No matter the channel, after consumers give the lender the minimum requested information, they expect the lender to give them a preliminary decision within seconds. Their expectations are now based on their Web interactions. They want instant decisioning. The borrower doesn't care about the back end. Just get it done, fast. Lenders are starting to understand this. So if they're going to invest, do it in the decisioning area."

Zoot's Lindeen echoes this sentiment. "The leading lenders have mastered automation," he asserts. "The next step is responding to market changes in real time or as close to real time as they can. You want to be able to respond quickly."

In fact, says Metavante's Cy Brin, president of the Milwaukee-based company's lending solutions practice, the whole subprime problem can be traced back to the decisioning capabilities. "The technology today can greatly reduce lenders' risk for loans not meeting underlying criteria," he says. "Our loan origination system has embedded decisioning that works as early as the first conversation with the borrower."

Michael Madsen, CTO and VP of product engineering for banking and investments at Fairfax, Va.-based CGI, takes a more big-picture view of the kinds of technology successful lenders will use. "What's really taking hold among banks to help deal with the lending crisis fallout and in the future is SOA [service-oriented architecture]," he explains. "SOA and BPM [business process management] are going hand in hand. It's imperative for lenders to get their heads around BPM first. This technology will help them become more agile with credit risk and their business in general. BPM will tie everything together. It will let lenders make

decisions at the top and drive them down through the organization." (For more on SOA, see related feature, page 32.)

Madsen also sees more lenders embracing technology that allows them to move the loan further out of the hands of IT. "Time to market is important," he says. "I'm seeing much more emphasis on technology that lets the organization move the loan further upstream out of IT. There's frustration on the business side around being able to move new products to market -- they often view the IT department as a bottleneck. So the business side wants solutions that give them more ownership and helps them bring products to market faster."

A Solid Channel Lineup

Another key component to a successful lending business in the future will be banks' channel strategies. According to Annette Tirabasso, a principal with New York-based Deloitte Consulting, the Web channel will take center stage. In a recent Deloitte study, "The Silver Lining in Lending," Tirabasso noted that moving much of the lending function online can yield banks from 50 percent to 80 percent in origination cost savings, in addition to meeting customers' service needs. The report also concludes that consumers tend to be happier with an online lending experience versus other channels and, as a result, are more likely to recommend their banks to others.

"Banks and lenders that provide strong delivery channels will be better positioned in the market when we come out of the crunch," Tirabasso says. "This is a way for them to position themselves for growth."

Metavante's Brin says this trend is starting to take hold. "I'm seeing more demand for Web portal-type capabilities a lender can implement to enable its customers to go online to get detailed information on the loan products and start or complete the application process," he relates. "This can be either online or at the branch via a kiosk."

Keeping People in Their Homes

Of course, getting the customers is one thing. Keeping them -- and keeping them out of trouble -- is another opportunity for lenders. Many are trying to create strategies where they work with customers who are at risk of defaulting and nipping the problem in the bud. Fiserv and other vendors offer customer/home-retention services to lending clients on an outsourced basis. They provide the lenders with the staff and technology to help them deal with an ever-growing volume of troubled customers.

According to Fiserv Lending Solutions EVP Walter Morgan, the company manages multiple pieces lenders need when they approach distressed borrowers for loan modification. "Lenders just don't have the staff to handle all the calls," he contends. "They're overwhelmed. We're taking the load off. The idea is to keep people in their homes. This service is in high demand now from our customers. They're all realizing that for the vast number of borrowers, mitigating loss and making modifications to loans to help keep the house saves everyone money in the end."

Bank of Nevada's Sleasman says monitoring existing portfolios is crucial to avoid foreclosures. "Lenders must pay attention to the portfolios they have. They have to use available technology to monitor them, [and] identify and evaluate existing loans that indicate trouble, such as when a customer overdrafts too much," he relates. "Work with the borrowers. We focus on full banking relationships with customers. If there are indications that there could be stress, we will talk to those people."

"Retention services is a great idea," adds TowerGroup senior analyst David Hamermesh. "Opportunities like this have been talked about since last fall. The tools are better to help banks do this effectively. But there are so many factors to consider here that make it challenging. First and foremost is making borrowers aware that they have options like this. I think everyone is trying to figure out how to do this best."