

Credit Decisions *in a*

In this uncertain environment, institutions should adjust their lending strategies to accommodate for relative risk at the state, MSA, and county levels.

BY JEFFREY S. MORRISON

THROUGHOUT THE FIRST half of 2008, the U.S. economy experienced a significant deterioration, as evidenced by an April report from the Bureau of Labor Statistics. The report revealed that, for the first time since 2005, the U.S. unemployment rate had topped 5%, signaling a continuation of the downward spiral in the labor market that began in the first quarter of 2007.

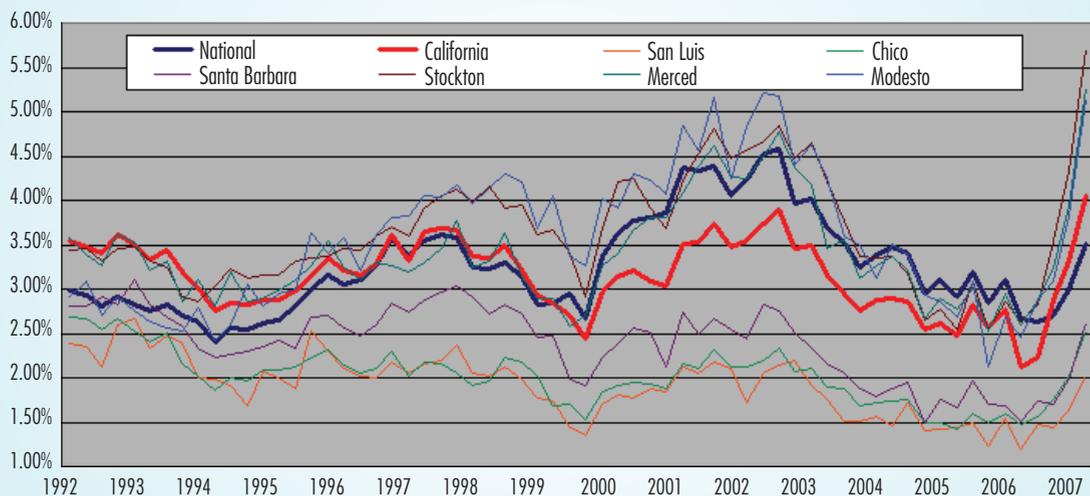
In mid-April of this year, the price of oil set a new record, moving past \$120 a barrel after a U.S. government inventory report raised concerns about supplies. And just the month before, the Bureau of Economic Analy-

sis reported that real gross domestic product (GDP), the output of goods and services produced in the U.S., increased at an annual rate of 0.6% in the fourth quarter of 2007. By comparison, real GDP had increased 4.9% in the previous quarter.

Last, but certainly not least, is the ongoing concern over the housing market. Simply put, housing prices for the past several years had risen much faster than was justified by economic conditions. A combination of factors caused prices to escalate, but it began with the Federal Reserve keeping interest rates exceptionally low for a long period,

Figure 1

California MSAs
All Trades: 90-Day Delinquency



Source: TransUnion

Changing Economic Environment

thereby encouraging many home buyers to opt for larger loans. Financial institutions contributed to the trend by engaging in relaxed and generous lending practices, issuing billions of dollars in subprime mortgages to borrowers with questionable repayment histories. Now, the median sales price of existing single-family homes is the same as it was in early 2005.

Credit Conditions Follow

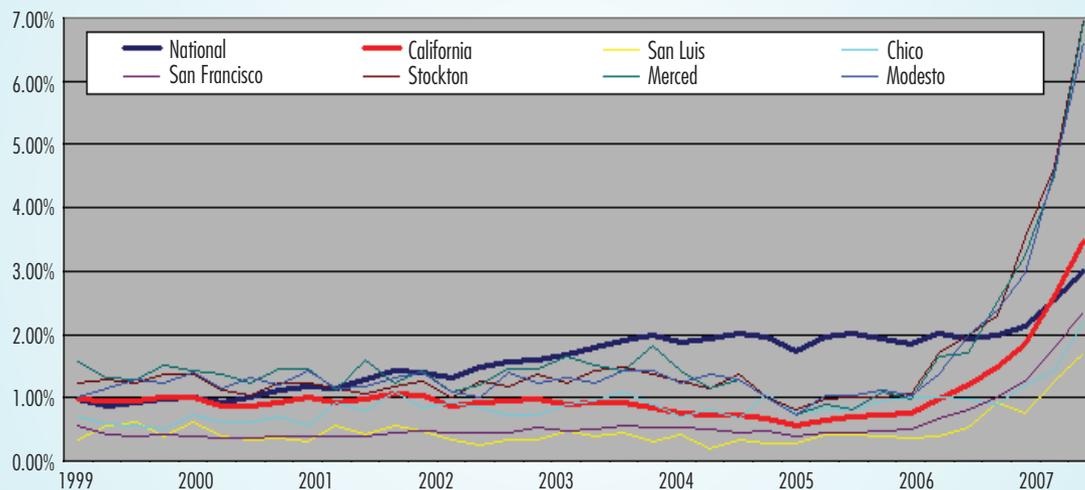
Unemployment, inflation, and consumer confidence are leading economic indicators of credit conditions, so it is

no surprise that national delinquency rates are now increasing. Because states differ from one another in terms of business sectors, commerce, income, and employment opportunities, repayment behavior in the states varies around national trends. This variance is similar to the credit conditions at the smaller geographic levels such as metropolitan statistical areas (MSAs) and counties.

Figure 1 highlights trends associated with the 90-plus-days delinquency rate (ratio of delinquent borrowers) for all trades, comparing the nation, California, and selected MSAs within California. In the early 1990s, California's

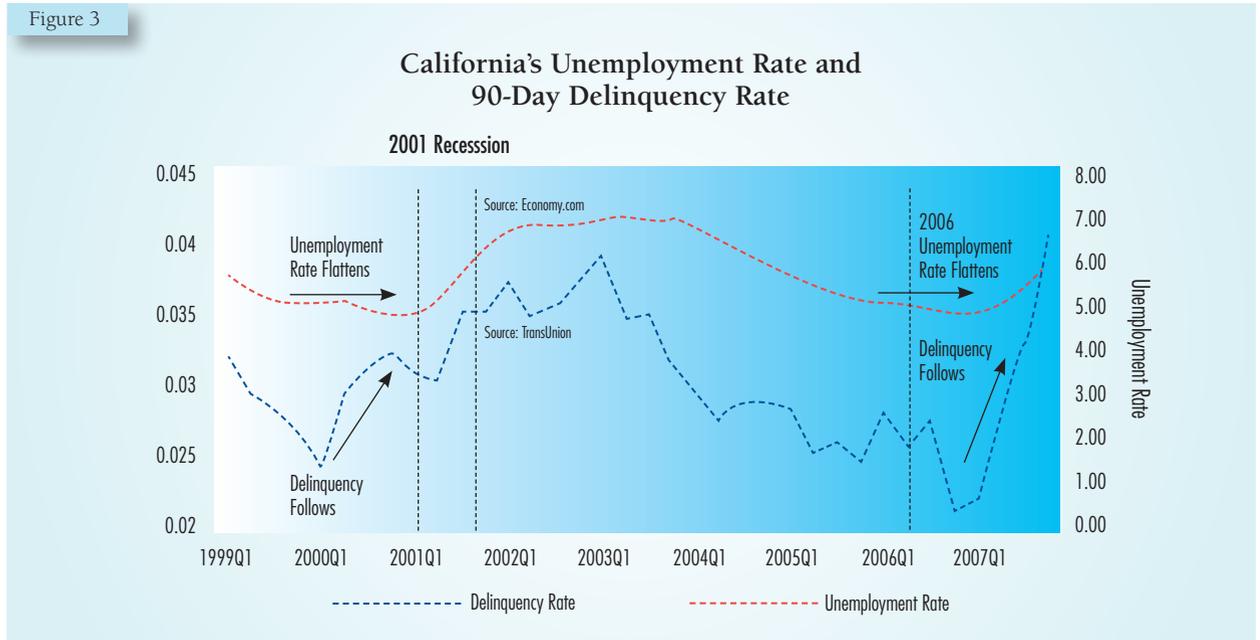
Figure 2

California MSAs
Mortgage Delinquency Rate, 60+ Days



Source: TransUnion

Figure 3



delinquency rate was greater than the national average, but it reversed itself around 2000. At the end of 2007, California's delinquency rate was once again higher than the national average.

For those financial institutions interested in servicing the California credit market, there are MSAs within the state that have attractive (low) delinquency rates and others that are particularly risky, even by California standards.

On the mortgage side, Figure 2 highlights trends associated with the 60-plus-days delinquency rate, again comparing the nation, California, and some MSAs within California.

For the most part, California's mortgage delinquency rates have been below the national average as far back as the early 1990s, with a reversal occurring only in 2007. This is not surprising given that California's housing market experienced dramatic price changes in recent quarters due to the effects of the subprime mortgage crisis.

Again, from a lending perspective, financial institutions wishing to service California would see some MSAs as potential opportunities for relatively less risky new loans in areas such as Chico, San Luis, and even San Francisco. On the other hand, Modesto, Merced, and

Stockton exhibit significantly higher delinquency rates—something to be considered in account management and

new account strategies, all other things remaining equal.

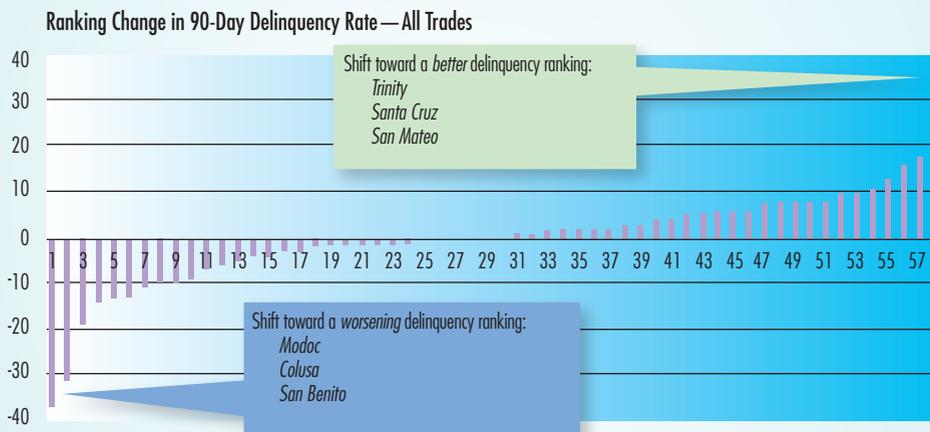
Now, let's try to put some numbers to some possible geographically based lending strategies. Our first scenario can serve as a baseline, representing a state-level strategy for California under a period of economic stability. Although this is a simplistic example, let's assume a lending institution makes 50,000 loans in the first quarter of 2000, randomly selected across California. During this period, the average credit score was 652, with an average balance of all credit trade lines of \$13,310. These numbers, taken from TransUnion's aggregated credit file, reflect the state averages associated with all trades at that period of time, including a 90-plus-days delinquency rate of 2.4%. The delinquency dollars associated with this strategy, all things remaining equal, would simply be $50,000 * \$13,310 * 2.4\% = \$15,972,000$.

Let's say the lender wishes to direct its strategies more toward the least risky California counties. Can the lender reduce its risk by using the knowledge that some counties in California are relatively less risky than others? The proof is in the numbers.

Again, assume a stable economic environment. In the first quarter of 2000, the 10 least risky counties in California had a delinquency rate of 1.22% with an average balance of \$11,317. Lending directly to these counties, all other things remaining equal, equates to \$6,903,370 in delinquencies—less than half the dollars at risk than in our broader state-based lending strategy. Remember, both of these strategies assume stable economic conditions—in other words, constant delinquency rates. How would they perform in a deteriorating economy? Furthermore, would insight into a changing economic environment help us improve our geo-

Figure 4

Changes in California's County Delinquency Rankings Before and After 2001 Recession



graphic lending strategies during a recession?

Lessons Learned from the Past

The National Bureau of Economic Research defines a recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. A recession begins just after the economy reaches a peak of activity and ends as the economy reaches its trough. Between trough and peak, the economy is in an expansion. Expansion is the normal state of the economy.”

Since 1975, the United States has gone through three recessionary periods, the last one ending in November 2001. By most standards, of the three recessions, the 2001 episode, which officially lasted only eight months, is considered to have caused the least damage to the economy.

Two of the most common questions lenders are asking in 2008 are:

1. How will a recession impact my portfolio?
2. How can I adjust my current risk and marketing strategies to mitigate losses?

To answer these questions, we need to do an analysis of the 2001 recession. As seen in Figure 3, California's state-level credit conditions in 1999 were optimistic owing to improving economic conditions. A reversal of that trend began in early 2000 as the credit market started to respond to a change in unemployment conditions from the year prior.

Prior to the 2001 recession, the unemployment rate dipped slightly, followed by a slight decline in delinquency. As we moved into the recessionary period, the

unemployment rate trended upward, followed shortly by deteriorating credit conditions. In 2007, we again saw unemployment leading delinquencies as unemployment flattened in the prior year, followed by deteriorating credit conditions shortly thereafter.

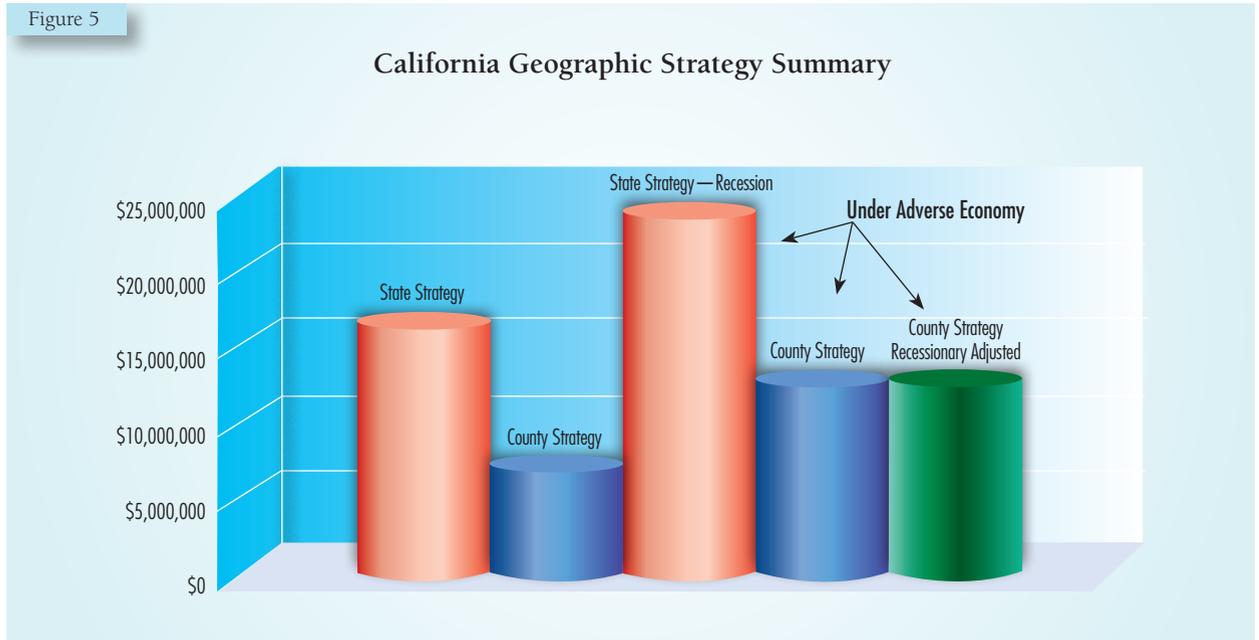
In early 2000, the credit market started to respond to a change in unemployment conditions from the year prior.

During the 2001 recession, how would our previous strategies hold up? For the state-level strategy of 50,000 loans using aggregated credit measurements at the end of the recession, we would have seen an average delinquency rate of 3.52% and an average balance of \$13,433, yielding an overall delinquency amount of \$23,642,080 (50,000 * 3.52% * \$13,433). This is almost a 50% increase in delinquency dollars at risk for charge-off. If we had used the 10 counties selected earlier, we would have seen an average delinquency rate of 2.24% and an average balance of \$11,350, yielding a delinquency total of \$12,712,000—still about 50% better than the state-wide scenario under recessionary conditions.

Now let's create a final scenario. Let's assume we had prior knowledge of the relative rankings or delinquency rate of California counties at the end of the recessionary period in 2001. If the financial institution adjusted its lending policies to reflect post-recessionary county distributions, would this strategy improve its risk position in terms of delinquencies outstanding?

Figure 4 shows how delinquency rankings shifted

Figure 5



within California on a county level during the time of the recession from the first quarter of 2000 to the third quarter of 2001. We use the 2000 time period as a baseline because it reflects the beginning of an upward trend in delinquencies for the state that carried through to the 2001 recession.

If we took the credit temperature at the end of the 2001 recession, certain counties like Trinity, Santa Cruz, and San Mateo were seen to have improved their relative rankings of 15 positions or more from the first quarter of 2000, although all areas experienced greater delinquencies. Unfortunately, counties like Modoc, Colusa, and San Benito took the brunt of the recession in California, experiencing deterioration in their relative delinquency rankings by 20 or more positions.

Instead of selecting the 10 least risky counties *before* the 2001 recession, let's use the 10 least risky counties found at the end of the recession. Lending to these counties would have resulted in a delinquency rate of 1.56% and an average balance of \$13,810, yielding delinquencies at risk of \$10,771,800—again assuming 50,000 loans. This is an improvement over the previous county strategy of more than 15%. A summary of these scenarios is shown in Figure 5.

Summary

Lending in today's world of economic uncertainty, coupled with high levels of consumer debt, is indeed a risky business. Sure, custom and generic scores certainly help and are highly recommended. However, in times of economic stability, or even in a recession, adjusting lending strategies to accommodate for relative risk at the state, MSA,

and county levels can further help the financial institution minimize its risk. This can be accomplished by using existing risk strategies such as adjusting score cutoffs and credit limits in conjunction with policies based on geographic overlays.

The California example was picked to illustrate that, even in a potential high-risk state, insight into MSA- or county-level risk profiles can help lenders considerably. If this same analysis were applied to the nation rather than to just California, the risk mitigation results for lenders would have been substantially larger owing to greater variations in risk across the 50 states, 300 MSAs, and 3,200 counties that constitute the U.S. consumer markets.

For smaller community banks located in riskier areas that do not have the luxury of constructing refined geographic risk strategies, other risk mitigation approaches are warranted. For example, the bank could pull back on its policies for cash advances, effectively lowering loan-to-value—say, from 80% to 70%. Although this may result in lower loan volumes, the effect would be a portfolio that is inherently less risky. ❖



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