

## Pinpointing risky borrowers

Impairment risk is now number one on the boardroom agenda, says **Frank Rohde** who explains how Customer Portfolio Optimisation can help to improve profitability

The current mortgage market is experiencing a great deal of volatility. Impairment risk, or the risk of deteriorating credit or collateral in lenders' existing customer portfolio is quickly becoming the number one boardroom agenda item among mortgage lenders in the United Kingdom.

A recent report indicated that the provision requirements for prime mortgage impairments will have risen from 0.05 per cent of balances outstanding in the first half of 2008 to 0.30 per cent of balances outstanding in the second half of 2009, and the provisions for specialist mortgage impairments will have risen from 0.28 per cent H108 to 0.94 per cent H209. This is expected to reduce forecast profits for the major banks and building societies by up to 32 per cent and may even lead to trading losses for smaller players where the proportion of fixed costs to total volume is greater.

Because of this volatility, mortgage executives responsible for profit and loss are dealing with unprecedented complexity in the market. Many do not have access to the information they need or the capabilities required to profitably manage through this difficult time. There are three key questions that mortgage lenders are grappling with when it comes to improving profitable customer portfolio management:

1. Which customers are at risk of impairment?
2. Which customers are at risk for prepayment?
3. Which customers are good candidates for cross-sell?

One of the greatest liabilities for mortgage lenders today is the impairment risk of deteriorating credit and / or collateral in the existing customer portfolio. Decreasing property values and a higher cost of living are changing borrowers' profiles and their behaviour.

For example, 60 per cent of total UK mortgage stock is less than two years old and it is estimated that 17 per cent

of balances outstanding have loan-to-value ratios in excess of 80 per cent. When these latter mortgages reach their rate reset date it is likely most borrowers will have no choice but to revert to their existing lenders' standard variable rate (SVR). This will increase their risk of default by raising their ongoing pay rate by up to two percentage points higher than the original deal rate.

### Customer risk profiles

Understanding which customers are at risk of impairment, knowing which product and price combinations would be most likely to offset this risk both for the customer and for the lender, and the best way to approach the customer with this new offer are the keys to managing impairment risk. See Exhibit 1, which highlights the areas of impairment risk where expected loss is significantly higher than average. The red squares represent the highest risk. Of the four main categories of customers, the home purchaser Introduced category



Frank Rohde

ry contains the highest expected loss as illustrated by the number red squares. It is not necessarily the most profitable strategy to let borrowers 'roll-over' to the SVR, since with LIBOR close to 100 basis points above bank base (and higher than swaps) there may be a fixed rate product/price combination which generates higher income and/or offers a lower pay rate (therefore reducing the financial pressure on higher risk borrowers).

### Prepayment risk

To make this situation all the more complex is the continued risk of the good quality customers prepaying their mortgages and choosing to remortgage with another lender. Prepayment risk is costly because the acquisition and administrative costs that were incurred to secure these customers may not be recovered. Many customers experience rate shock when the promotional rate term expires.

At this time, some good quality



## There are many opportunities for cross-sell. The difficulty is identifying the right set of customers and providing them with the right set of offers to increase the likelihood of success

customers are happy to revert to the lender's SVR, while others begin shopping for more attractive options. The trick in this situation is to identify which customers are most likely to defect, offering the right product and price combination to keep them without needlessly sacrificing margin, and reaching out to them in the most effective way.

### Cross-sell strategy

The third leg of the stool, which hasn't received as much attention in the news

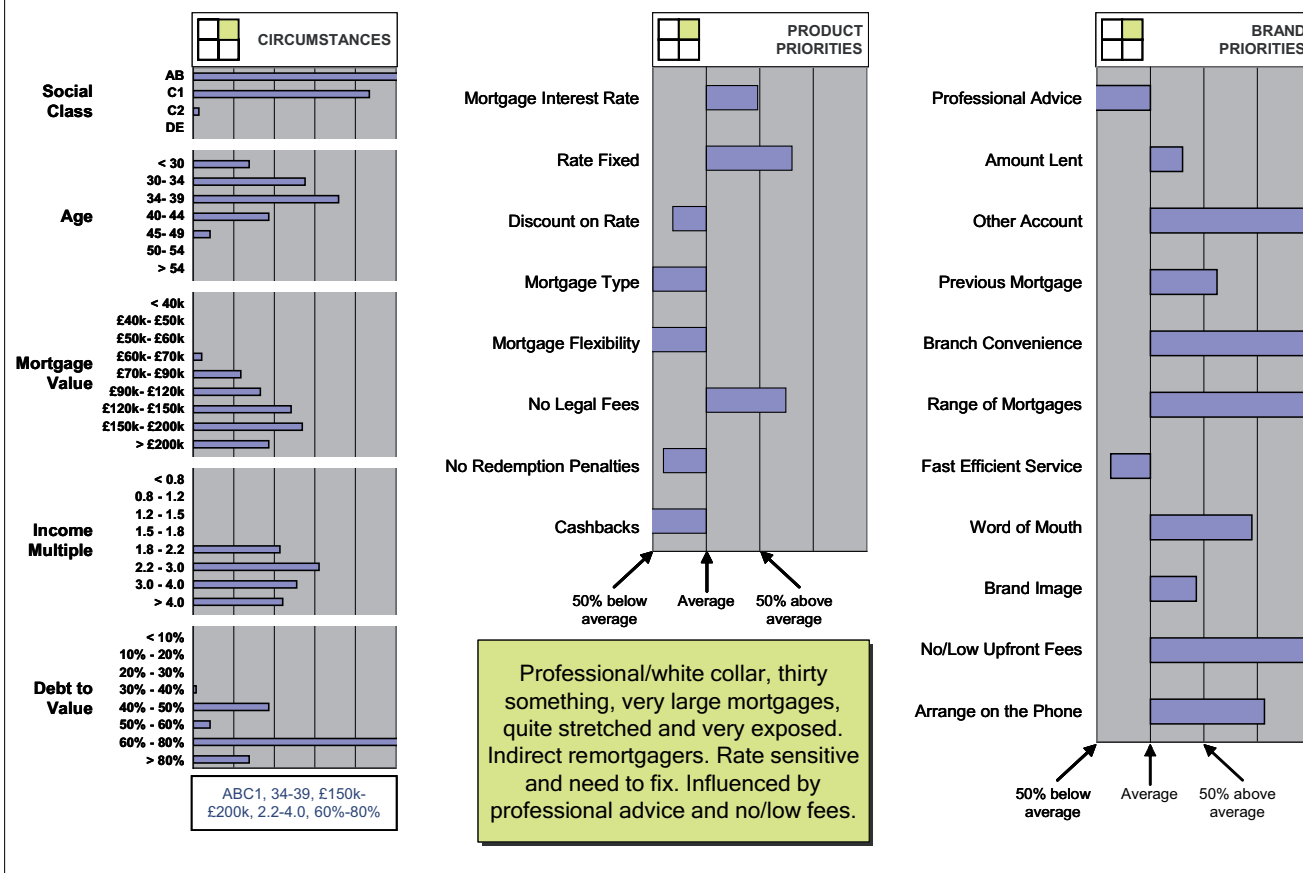
as of late, is to identify those customers who do not currently use all the lender's products. Once identified, the lender can determine the most appropriate cross-sell strategy in order to increase share of wallet and profits. For example, would this customer benefit from using the same institution for savings or deposits? Would they switch credit card providers or open a line of credit with the lender? There are many opportunities for cross-sell with existing customers. The difficulty is identifying the right set of customers and providing them with the right set of offers to increase the likelihood of success.

Contacting all customers in the portfolio that are at risk for impairment or prepayment or who may be good cross-sell candidates is a costly and unadvisable approach to profitability management. Mortgage lenders can use a more advanced, tailored and more effective approach to customer portfolio management. Customer Portfolio Optimisation enables mortgage lenders to answer these questions and develop effective strategies for managing impairment risk, prepay-

## Executive Summary

- The keys to managing impairment risk are: to understand which customers are at risk of impairment; knowing which product and price combinations would be most likely to offset this risk, for both customer and lender; and the best way to approach the customer with this new offer.
- Customer Portfolio Optimisation enables mortgage lenders to develop effective strategies for managing impairment risk, prepayment risk, and cross-sell opportunities.
- The methodology marries an understanding of customer preferences and needs with behavioral data and a current assessment of their borrowing situation.
- Once the lender has a deeper understanding of customers in the portfolio it is in a much better position to develop a unique contact strategy for each segment. It quickly becomes apparent which groups of customers should be contacted and which should not.
- A Customer Portfolio Optimisation approach uses customer segmentation as the basis for product configuration. The ability to configure the right combination of features such as administration fee, rate type (fixed or tracker), product term, LTV threshold, prepayment fee and the optimal pay rate for each customer segment, increases the likelihood of achieving financial performance objectives.

Exhibit 2: Segment 16



ment risk, and cross-sell opportunities based on a better understanding of customer preferences, optimisation capabilities, and a more efficient process. The Customer Portfolio Optimisation process includes three steps, as outlined below.

### 1. Developing actionable customer segmentation and contact strategy

The first step to successful Customer Portfolio Optimisation is segmenting the existing customer portfolio into relevant and actionable customer segments. Customers can be segmented based on a number of various characteristics, but the most beneficial segmentation enables a lender to understand which action to take with each segment.

The Customer Portfolio Optimisation methodology marries an understanding of customer preferences and needs with behavioral data and a current assessment of their borrowing situation. For example, see Exhibit 2, which details one particular customer segment: segment 16. This segment contains professional/white collar, thirty something customers with very large mortgages who are influenced by

## Presenting the right offer to the right customer is the goal of all mortgage lenders, however, it is a very difficult goal to achieve with traditional methods

professional advice and no or low fees. They are indirect remortgagers, quite stretched, very exposed, rate sensitive and need a fixed rate product. This segment prefers to be contacted by phone,

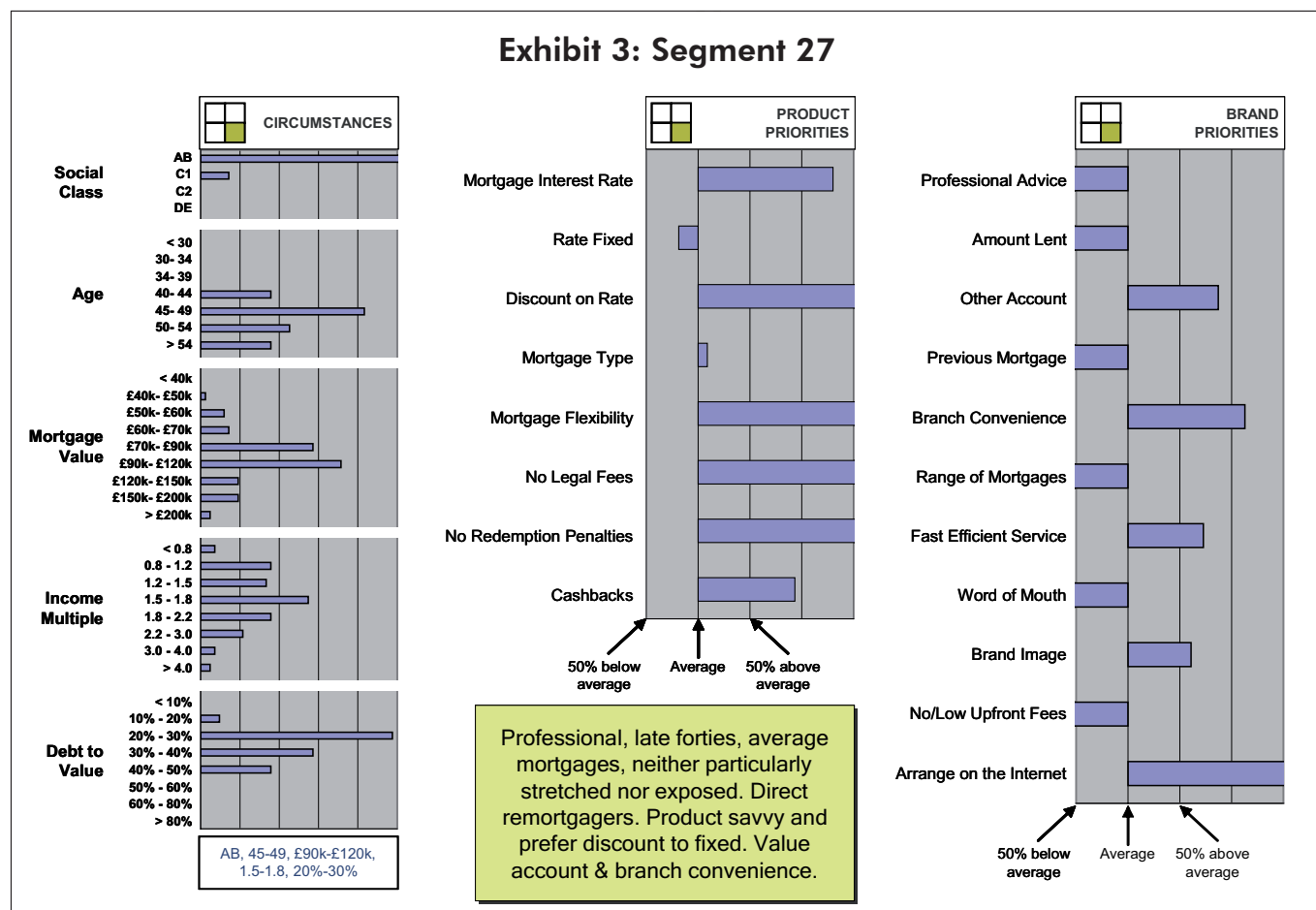
On the other hand, Exhibit 3 features segment 27. This segment contains professionals in their late forties with average sized mortgages that are product savvy and prefer discounts to fixed rate products. They value account and branch convenience and are direct remortgagers who are neither particularly stretched nor exposed. This segment prefers to connect on the internet. Having this type of insight about each customer segment drives a more effective strategy and set of action steps.

As mentioned above, contacting all customers is ill advised. Once the lender has a deeper understanding

of the customers in the portfolio and good knowledge of the impact of each on the overall portfolio, the lender is in a much better position to develop a unique contact strategy for each segment. By evaluating each segment, it quickly becomes apparent which groups of customers should be contacted and which should not. Using the segments identified above, the lender could decide to develop a proactive telephone-based contact strategy for segment 16 and a reactive contact strategy for segment 27.

### Tailoring the right offer for each segment

After determining which segments to proactively contact, the lender has a significant and complex decision to make. Presenting the right offer to the right customer is the goal of all mortgage lenders, however, it is a very difficult goal to achieve with traditional methods. Which product features and pricing combination will best meet this customer segment's needs? Most lenders rely on a set of pre-existing products and pricing options at this stage of the customer portfolio management process. Some use a customer-to-offer matching tool



or direct marketing decision tools. However, these approaches have an inherent flaw: the new offer has not been specifically created for a particular customer segment, which decreases the chances of success.

A Customer Portfolio Optimisation approach uses customer segmentation as the basis for product configuration. The ability to configure the right combination of features such as administration fee, rate type (fixed or tracker), product term, LTV threshold, prepayment fee and the optimal pay rate for each customer segment, increases the likelihood of achieving financial performance objectives.

For example, some lenders using the Customer Portfolio Optimisation approach are developing product offers specifically for customer segments identified as having higher than average impairment risk. These products may be structured in such a way that the pay rate is lower for the next two or so years then gets higher after the current market cycle is forecast to bottom out. In this way the immediate payment shock is reduced, and the actual risk of delinquency minimised (or at least postponed until after property values start rising again and mortgage availability improves).

Pricing optimisation or determining the optimal price for a particular product for a specific customer segment requires an understanding of customer response (or demand elasticity) to various offers and the impact of that response on key performance indicators (KPIs) such as profit volume and risk.

Traditional approaches to pricing include cost or risk-based, market-based and anecdote-based methods, all which have one fundamental flaw in common: failure to take the customer's preference and response into account. Below are examples of the most common pricing approaches used by most mortgage lenders.

Pricing optimisation replaces these antiquated and inaccurate methods with a more scientific approach. Based on an ongoing analysis of customer transaction data and price response, pricing optimisation enables mortgage lenders to better understand the impact of rates and fees on KPIs before distributing offers into the market.

## 2. Developing the most effective outreach strategy

There are four key factors that should be considered in the outreach strategy development process. The first is tim-

ing of the outreach. When should the lender contact the customer segment about the new offer? One month after rate reset? One month before rate reset? What is the right frequency of contact?

The next factor is sequencing. If the customer does not respond to the first offer, should the lender make that same offer again or make a new offer and how soon after the first offer was made? The use of the most appropriate channel is also a key factor to consider. Should you reach out via phone or send a letter to this customer segment?

## Impairment risk has taken over as the most important issue to manage, however it should be balanced with prepayment risk and the opportunity to cross-sell in order to increase profitability and share of wallet

Finally, what should the tone of the message be? Some customers respond to an advisory tone while others prefer feeling appreciated for their loyalty. The answers to these questions can be uncovered with improved segmentation and a better understanding of customer preferences.

Four mortgage lenders in the United Kingdom are currently using a Customer Portfolio Optimisation approach and are achieving the following benefits:

- a. Financial results: Generating 5 to 10 basis points of incremental income for assets at risk.
- b. Customer insight: Leveraging actionable customer insights to drive business strategy and improve performance.
- c. Process improvements: Fortifying customer management by using a more structured, efficient and compliant process.

### Conclusion

In order to better manage through the volatile market, mortgage executives must explore more advanced methods for profitably managing their customer portfolios. Impairment risk has taken over as the most important issue to manage, however it should be balanced with prepayment risk and the opportunity to cross-sell in order to increase profitability and share of wallet.

## The most common pricing approaches used by mortgage lenders

**Most mortgage lenders use one or a combination of the following approaches to guide pricing decisions to determine rates and fees:**

- 1) Cost or risk-based pricing: Rates and fees are set based on cost (cost of funds plus risk plus fixed margin). This approach ignores competitive pricing as well as the differential price response of different types of customer.
- 2) Market-based pricing: Rates and fees are set based on competitive prices, which doesn't take into account the value a customer places on the brand, product, service or the profitability of the loan.
- 3) Anecdote-based pricing: Rates and fees are set based on rules of thumb, which doesn't take into account current market and competitive realities.

Customer Portfolio Optimisation provides mortgage lenders with a more tailored and efficient approach to managing the existing portfolio. Customer Portfolio Optimisation enables mortgage lenders to more profitably manage their business using a three step process. First, it helps lenders develop actionable customer segments and identify the most appropriate contact strategy. Second, it facilitates the tailoring of offers for each customer segment (including product features and optimal rates and fees). Third, it helps lenders develop the most effective outreach strategy in order to achieve business objectives and performance goals. **MFG**

*Frank Rohde is responsible for managing Nomis Solutions' European operations and global marketing efforts. He has a wealth of expertise within financial services spanning over 15 years and has worked with a range of the world's largest financial services clients on product development, marketing, and pricing problems. He is a frequent speaker at industry events and has published multiple articles on decision management and optimisation. Website: [www.nomissolutions.com/mortgages](http://www.nomissolutions.com/mortgages) or call +44 (0) 207031 8284.*