Branching Out: A retail banking podcast series

Season 2, Episode 1: Retail banking credit and analytics: Evolving trends at the edge

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Bill Dworsky: Hi, everyone. Welcome to *Branching Out*, the podcast where we explore trends in retail banking through conversations with leaders from across the financial ecosystem. I'm your host, Bill Dworsky.

Kristin Korzekwa: And I'm Kristin Korzekwa. On today's episode, we are so excited to talk to Dave Wasik, a partner at 2nd Order Solutions. Dave, great to chat with you and thank you so much for joining us.

Dave Wasik: Yeah, great to be here, Kristin and Bill. And thanks for having me.

Bill Dworsky: Well, Dave, I would love to just start by maybe a little bit more about your background before 2nd Order Solutions. I know we're going to dig into a lot of awesome topics around credit, customer analytics, and other things, but I'm curious how you got kind of into that area and started focusing there in banking.

Dave Wasik: Sure, yeah. I've been in consumer and small business credit and lending for—I'm shocked to say—over 30 years now. I started my career with Capital One. I joined there in the early '90s and was there during Capital One's IPO and growth stage to becoming one of the largest banks in the country. I was there for a total of 17 years. Got the chance to play a lot of different roles within credit, lending, analytics. I had the pleasure or misfortune of leading collections and recoveries for the US card business during the Great Recession. And lived to tell about it. And then also, I spent several years in the small business cards and loans line of business. In the beginning of 2011, I left Capital One to take (still) a consumer lending role, but a really different one. I led global operations for a microfinance network and had the chance to apply consumer lending principles in Africa, Eastern Europe, Latin America, and Asia, and was there for about six years. And then have joined 2nd Order Solutions. I've been here now about five years. And just a bit on 2nd Order Solutions, or "2OS" for short: We're a credit risk advisory firm, so we work across the credit life cycle from acquisition-stage credit, managing credit, and exposure on existing customers. Do a lot of work in fraud and collections. We work with some of the largest banks in the world as well as a lot of up-and-coming fintechs. We're a US-based firm, but we increasingly are doing more and more work outside of the US. So, credit risk and analytics is our niche, but we try to provide a great breadth and depth of services within the credit risk space.

Bill Dworsky: So, Dave, you mentioned a little bit about some of the focus areas within 2OS and some of the primary aspects of credit analytics that the company's focused on. And I think recently, 2OS completed a review of credit risk, trends, and results. Looking a little bit backward toward Q4 2023, kind of year-end recap, what are you looking out for most closely in 2024, as we look ahead on the credit risk front? There's a lot of commentary markets on things to watch for. I'm curious what are you most keenly focused on or thinking about?

Dave Wasik: Yeah, no, thanks, Bill. Every quarter, 2nd Order Solutions puts out a broad consumer credit report looking at the state of originations, losses, and delinquencies across the major consumer lending categories. One preface I want to give to this answer is you'll see soundbites both in our reporting and elsewhere about 2023 performance is 30% worse than pre pandemic, and that sounds really bad. But if you rewind the tape back to 2018, 2019, before the pandemic, that was actually a period of very low credit losses. In fact, at the time, credit losses had been so low for so long that a lot of us, and a lot of our counterparts with our clients, were worried about a natural reversion to 30-year norms. What we are finding is that loans originated during that 2022, early '23 time period are performing particularly bad in the credit card space, in the personal loan space, and in auto. And if you are a large retail bank and you've got a massive portfolio and you've got 20 years of loan originations to draw from, a bad 2022 vintage, you're going to notice it, but it's not going to be an existential threat. Where we see the challenges are some of the fintechs that may have been founded in 2020–2021, where some of these more problematic vintages are a large percentage of their business. That's where, again, a bad year-and-a-half worth of originations can really be challenging. And so, the impact of this worsening differs greatly by product type, but then also by the category of lender that we see. In terms of what I'm looking for this year, two things. One, we're beginning to get a read on loans originated in late '23, and eventually as the year goes on, we'll start to get an early read on early '24 originations. I think that will be very telling because over the past 12 to 18 months, most lenders have tightened their underwriting standards. And so, when we see tightening of underwriting, what you'd want to see is improvements on a vintage-over-vintage basis. And so, if we don't see that improvement, or if we see continued worsening, that would be a sign that all things being equal, the environment is continuing to get riskier. The other closer-in trend would be related to student loans. As you know, student loan payments resumed at the end of 2023, but reporting to the credit bureau doesn't resume until September of this year. So, firms like ours, and if you're trying to get a clear view of what the repayment rates look like across the industry, we're a little bit in the fog right now when it comes to what those repayment rates and delinquency rates are looking like. So, I'm very eager to see what those delinquency rates are looking like and what that means in terms of the overall credit performance at the household level, not just at the loan level.

Kristin Korzekwa: Wow, interesting. Yeah. So, you touched a little bit on some of the unique product distinctions there, and what you've seen and what you're expecting. Anything further, I mean, even maybe outside of the student population, where you're seeing any specific nuances within different customer segments?

Dave Wasik: Yeah, sure. I'd highlight a couple things. One is we are seeing millennials are struggling, in part from a credit perspective, but we're finding that the rate of homeownership and the purchase of new homes is tracking well below that of previous generations. That's driven in part by that generation has more student loans to contend with than any past generation. We're seeing elevated interest rates and most importantly, high home prices and high prices of new and used cars. That's making a more traditional path of, well, you start by establishing credit by getting a credit card, and then you buy a used car, and then eventually you buy a new home. The millennial generation is making their way down that path at a slower rate than prior generations. But I think it is going to be one of those macro trends that a lot of us both in the banking sector and those of us that work with banks need to be very mindful of. One other thing I'll talk about maybe that's more product-specific relates to auto loans, where driven by the interest rate increases as well as high rates of car price inflation, though the percentage of auto payments that are in excess of $1,000 a month has gone up to almost 20% as of the beginning of this year. And so, that not only contributes to some of the more generational issues that I described earlier, but it also makes me interested and a bit concerned about debt burden. So, what is the overall monthly payment that a customer needs to make across their credit cards, their personal loans, their auto loans? And again, for several different reasons, we're seeing an increase in that overall monthly payment, which we know based on past credit downturns is often a leading indicator of a more significant downturn.

Bill Dworsky: Dave, you mentioned the distinction between longer-standing institutions with potentially bigger and just more diversified by vintage portfolio across multiple origination years or decades versus newer organizations may have been even started in the last two, three, four, five years that could be more concentrated in specific years. I think it's an important distinction to make. For some of those organizations that especially are newer to the game, so to speak, do you see them bringing any distinctive credit risk management tools or other just sort of innovative approaches to how they're assessing credit that may help them better handle that in the near term?

Dave Wasik: Yeah, sure. So, since we have the opportunity to both work with a lot of people in the fintech sector as well as a lot of retail banks, generally speaking, we find that the fintechs as you would expect, have a more advanced set of capabilities around areas like data sciences. You all have probably heard retail banking clients say something to the effect of, "Gosh, I wish we could just nuke this entire loan system and start over." Well, guess what? The fintechs kind of had the ability to start from scratch. And that means that a lot of the areas around digital transformation, around using APIs [application programming interfaces] and the ability to ingest model scores, like their systems do that today. Whereas that requires a huge either system rebuild or a lot of system upgrading for a lot of retail banks to get to that point. So, if we talked earlier about some of the disadvantages that the fintechs had because of when they were founded, and the criticality of those late-pandemic vintages, the advantage they have is, generally speaking, a much more sophisticated and digital-ready tech platform. They, as a sector, have invested earlier in not just their data environment, but data scientists, to build machine learning models. And so, for institutions of their size, generally, they're ahead of the game when it comes to differentiating risk both at acquisition stage and throughout the customer life cycle. And so, yeah, they've got some inherent technological and talent advantages, which I think for the best of the fintech sector will help them tremendously in the years to come.

Kristin Korzekwa: So, I guess, building on that, knowing that when most people think about their lender or their credit provider, most of our clients, our larger institutions… I mean, where do you see the most promise for the future? I mean, is it really investing in those data and analytics capabilities in system advancement or are there other areas, like talent that you mentioned, where you think that retail banks should really think about innovating and investing in the coming years?

Dave Wasik: Yeah, no, it's a great question. And if I were to differentiate between like the large or the giant retail banks from regional banks or even some of the super regionals, not only have scale in terms of operating scale, like the way we're all taught to think about like scale in terms of unit cost and operating efficiency. But they've got data scale, they've got technology scale, they've got talent scale. And so, whether it's technology or talent, if you think about where lending is going towards being more and more data-driven, more and more sophisticated technology and data sciences, those top banks just have a lot

of inherent advantages. And that doesn't mean things are hopeless for the regionals and credit unions and people who are below them in the lead tables. It's just a challenging picture going forward on how to compete on the consumer-lending portion of the balance sheet.

Bill Dworsky: Dave, one related question: How much do you see actual, like manual, or sort of judgmental underwriting still happening in different parts of the retail bank? I'm curious, where do you see like actual humans making lending decisions versus building credit models for automated decisioning? I'm curious, what are your thoughts there?

Dave Wasik: Yeah, as you pointed out, it tends to vary a lot by the size and scope of the bank. Obviously, 20 years ago, I think you saw a lot more judgmental underwriting both on the loan origination side as well as making decisions on when to restrict the use of the loan, how to make decisions around reloading a term loan, etc. And over time, obviously that amount of judgmental underwriting has declined. I think there are certain edge cases where we do continue to see manual underwriting used. I think the challenge I would give to the retail banks is one, to the extent that judgmental underwriting is bringing information to bear on the customer in a manual way, not an automated way, well, how can that process be more automated? So, let's say that you are a bank that's evaluating a settlement offer for a customer that's in collections. If the way the manual underwriter is making that decision is by looking at their deposit balance, well, why isn't that deposit balance automatically available when they're evaluating that? And so, using the expertise of the manual underwriter as a way to prioritize new data sources to automate, rather than continuing the manual journey, is one push or word of encouragement that I'd give the retail banks. The other thing we find going back to these more sophisticated models is we've had a couple of clients that have used analytics to identify, "Hey, who are my best 10% of my judgmental underwriters?" And they spend a lot of time with them understanding, "Well, what is it exactly that you do because you're doing something right." And one, that's a training opportunity on how the best 10% can make the other 90% better. But it's also something where if you can take the mental algorithm that these top 10% are using and start to incorporate those as features into your models, then that makes the automated underwriting more successful while still preserving a place for the judgmental underwriters.

Kristin Korzekwa: Oh my gosh, so many different directions we could go with that. I'm so intrigued by a lot of what you just talked about, Dave. But maybe just on that point, what are your thoughts specifically around the types of data sources that banks are now using or what they're pulling into some of those algorithms for decisioning? What are you seeing in current models, and where do you think that's going?

Dave Wasik: Yeah, I realize I've spent a lot of time painting a gloomy picture of what the retail banks can and cannot do. But one huge advantage that retail banks have is they tend to have both sides of the consumer's balance sheet where they've got multiple loan relationships as well as, ideally, multiple deposit accounts. And that proprietary data is gold. That is something that—with all the advantages that we've been talking about that the national scale lenders have—the ability for retail banks or regional banks to get the most out of their proprietary internal data as possible is tremendous. And so, one area that I think, again, a really great advantage to be built on is the availability of all of these different multi-product relationships combined with a more and more sophisticated use of the external data sources that are out there that can help on the credit scoring side, fraud identification side. And again, the real power is in the proprietary data.

Kristin Korzekwa: So, I don't think we can talk about credit without talking about the CFPB [Consumer Financial Protection Bureau], right? Any thoughts, Dave, given the recent late fee ruling that was just updated? What impact do you think that will have either on card users or issuers in the future?

Dave Wasik: Yeah, it's a great question. So, again, just a quick summary of what the regulation is: This would cap late fees at $8 per incident, which depending on the issuer is down from, say, somewhere between the low $30s and up to $40 per incident. I'll mention—just given we've been talking about small banks, medium-size banks, and large banks—the way it's currently written, it only applies to banks with more than a million open credit card accounts. So, for many credit unions and even regional banks, they are technically out of scope for this legislation. And so, the real focus of this from a reg development

perspective is on the top card issuers. This is a great example of a more philosophical question of "What does it mean to be a customer-friendly regulation or a customer-friendly loan product?" And you can define the phrase quote "good for customers" in a few different ways. One would be how expensive is it as measured by cost of credit, fees, and interest as a percentage of the total balance. You could also define it as is it transparent? Do customers understand the deal that they're getting? And is that part of it clearly communicated and intuitive for the customer? Another is more of a financial inclusion kind of view of it is, will more and more customers get access to credit as a result of this regulation happening? One thing about the late fee in particular—and I don't mean to be the late fee cheerleader here—but one thing that's useful about the late fee is that it leads to higher cost of credit for people who don't pay on time and a much lower cost of credit for people who do. And with late fees generating a lot less revenue, and with lenders inevitably responding by increasing membership fees or increasing interest rates, membership fees and interest rates impact everyone whether you are paying on time or not. And so, I think this will lead to lower approval rates, lower lifetime values for the credit card account. One of the things I'm curious about is to see how banks and card issuers respond. What are some of the new product designs that they come up with in response? What are some of the fee and interest rate-related changes that they make either for new loan acquisitions or on the existing loan portfolio? I'll be curious to see how all of that plays out.

Bill Dworsky: We talked a lot about consumer. You also, mentioned the value from a retail bank's perspective of having a broader viewpoint of the entire customer relationship, bringing multiple types of data sources from their interactions with customers on different products, to credit and analytical decision-making. One thing that was on our minds also, when it comes to different customer types, was small business. Are there specific things, when you think about small business credit underwriting, whether it's for a card, whether it's for a different type of small business lending product, that you would say retail banks should be really focused on and thinking about how to incorporate differently into their strategy for small business versus when they're thinking about consumer or lending?

Dave Wasik: Over the past 5 or 10 years, there's been a lot of advancement on small business-centric data sources. So, this is an area where the bureaus have invested a lot. There's a lot of non-bureau data sources who have a particular focus and expertise on small business. And that has allowed small business underwriting to be as useful from an automated underwriting and modeling perspective as on the consumer side. And so, that's been one huge area of improvement in small business lending over the years. But honestly, succeeding in the small business space remains elusive for lots and lots of big banks out there. But it is something where we know that the relationship matters and being able to help small business owners on both sides of their balance sheet is really important to them. And so, it's an area that while there are some strategy things to get right, some data things to get right, it remains an area of innovation and an area of like competitive advantage for medium- to large-size retail banks.

Bill Dworsky: Yeah, it feels like it's a little bit of like the unicorn for retail banking profitability. Always seeking, always out there, always shifting and changing in different ways. Well, Dave, this has been fantastic. Anything that you feel like we haven't covered?

Dave Wasik: Yeah. I always like to talk about collections. Some of the themes that we've talked about already in terms of the importance of digital, the importance of technology, the ability to use these more advanced risk scoring techniques, all of that applies really well to collections also. Collections is on a 20-year journey from being entirely inbound and outbound phone-driven to being more of a digital-first approach. And that leads to a lot of implications around strategy, around technology, around what the operating model and talent needs for collections end up being. And now, we're seeing more and more cases where there is a head of digital marketing for collections because so much of the leverage now is in not just getting the right frequency of contact but saying the right things, and using the right tone of voice, the right calls to action. A lot of those things which have been table stakes for banks when they acquire customers but just have taken a lot longer to make their way into collections. And so, the importance of advanced analytics, digital collections, especially as losses and delinquencies rise is another hot topic within the credit space these days.

Bill Dworsky: Love it. Hey, I think that's a great note to end on. So, thanks so much, Dave. We really appreciate all the time and great conversation from today. And thanks to our listeners out there for tuning in to today's conversation. Thanks also to our Deloitte teammates who made this episode possible along with our friends at Hangar Studios. If you're looking to go deeper on some of the topics we talked about today, check out our podcast webpage online, deloitte.com/branchingout, where you'll find some short show notes and some relevant links from our conversation today. As always, if you have ideas, suggestions, other feedback about the show, drop us a note at branchingout@deloitte.com. And we look forward to exploring the future of retail banking with you again soon. Bye for now.

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