Strategies for Minimizing Portfolio Risk

What you need to know about the P&L approach.

Introduction

Whenever credit union credit card portfolio managers discuss their top priorities, they typically tell us that their goals center around growth, increased profitability, and—almost as an afterthought—risk minimization. It seems that many credit unions want to master which levers to pull to increase their card portfolios' upside potential but relatively few realize that they can employ equally specific strategies and tactics to manage and minimize their portfolio risks.

Here at Advisors Plus, our Risk Management and Collections team thrives on teaching credit unions that not only are there proven techniques to help them mitigate portfolio risk, but those techniques—used as a matter of course by the Big Banks—can and should be a part of every credit union's toolbox.

Risk Management 101: Moving Beyond Delinquency and Charge-off Rates

When beginning a portfolio risk analysis, it's easy to "jump to conclusions" and head straight to delinquency and charge-off rates as the key metrics for evaluating the credit quality of a card portfolio. While no risk analysis would be complete without them, we believe that taking an overall P & L approach that emphasizes net income and ROA provides a more balanced and nuanced picture of overall portfolio health.

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What you need to know about the P&L approach.

When analyzing the performance of a portfolio, there are a number of attributes that must be carefully evaluated. The key factors that must be examined as part of a credit card P & L statement include three key revenue components:

- **Interest income** is driven by balance and pricing. So for this metric, the questions become: Are balances growing, static or declining? Is pricing producing the appropriate yield for the risk in the portfolio, and is it generating the appropriate level of income? How do these balance and pricing metrics compare to industry benchmarks?
- **Interchange revenue** is driven by volume of purchase transactions. For this metric we look at volume per gross active account and interchange revenue per gross active account. There are industry benchmarks for interchange as well.
- **Credit line management** represents an important element affecting both interest income and interchange revenue. Are credit lines sufficient to give the good accounts the capacity they need to deliver both balance growth and purchase volume?
- **Fee income** is driven predominately by late fees, so the important elements here become the dollar amount of the late fee and the timing of when the late fee is charged.

On the expense side of the income statement, Cost of Funds, charge-offs, accrual for rewards redemption, normal operating expense and overhead are the key components. Our approach at Advisors Plus is to apply fully-costed amounts to the credit card portfolio.

Benchmarking the Risks: Are the Metrics in Line with the Market?

Our team uses a variety of tools to help us assess the risk profile of an individual credit card portfolio:

- **A vintage analysis** is an excellent tool to assess the risk profile and segment the credit card portfolio by current credit bureau score ranges, as well as by the year in which the accounts were acquired. Such a matrix approach allows us to evaluate both credit risk within the portfolio and targeted marketing opportunities that may be hidden within the portfolio.
- Credit union industry benchmarking is available through the Advisors Plus proprietary database of credit card delinquency and charge-off information that we have developed through various PSCU Member-Owner programs.

- Unique geographic or market area benchmarking is also available, and those analyses can be further refined by peer group analysis based on asset size.

Formulating a Risk Management Roadmap

When the delinquency and charge-off rates in a given card portfolio are revealed to be higher than those of its peer credit unions or the market as a whole, there are a variety of actions that can be taken to address this situation. However, it is important for a credit union to understand that progress is incremental and happens over time. The reality is that it most likely took a number of years for the problem to surface, and it will take some time to correct. The key things to remember are that such situations are correctable and that it is never too late to take immediate action. A comprehensive portfolio review will guide the targeted actions needed, with particular attention to the areas identified below:

- **Underwriting:** Based on a review of current and historical underwriting practices and policies, appropriate adjustment can be made to restrict the amount of risk allowed into the portfolio. This level can then be monitored over time to determine when the more restricted underwriting criteria should be adjusted.
- **Targeted Growth:** High-quality accounts within the portfolio should be identified and specific marketing campaigns targeted to them, with the intent of growing the portfolio's "good" balances, while diluting the negative effects of the higher-risk balances.
- **Targeted Credit Line Increases:** This strategy works hand-in-hand with the targeted growth initiative described above and provides increased capacity for targeted high-quality accounts with the goal of growing them through balance transfers and new purchase activity.
- **Pricing:** The current pricing structure of the portfolio should be evaluated to determine if it is appropriate for the portfolio's overall level of risk. A new pricing structure may need to be adopted for existing and/or new accounts to increase the revenue side of the business.
- **Optimize Collection Efforts:** By adding an additional skilled collection resource or outsourcing collections to another institution, the overall collection effort on the portfolio can be ramped up to a more aggressive level. While such increased efforts may only be needed on a temporary basis, they will nevertheless be highly effective in jumpstarting efforts to drive down delinquency and charge-offs.

Ready, Set, Grow: Capitalizing on the Upside of Risk Management

Clearly, no two credit union credit card portfolios are ever alike, which means that the overall level of risk associated with individual portfolio dynamics must be dealt with on a case-by-case basis. In our experience at Advisors Plus, however, every credit union—regardless of its precise demographics—can benefit by viewing portfolio risk minimization as a major opportunity.

Advisors Plus

Founded in 2004, PSCU's Advisors Plus offers consulting services for credit unions to help fuel growth and achieve financial and business goals. From project analysis to implementation and management, Advisors Plus offers an end-to-end portfolio of consulting services including business strategy, business and affinity cards, credit and debit cards, contact center optimization, risk and collections analysis, branch sales training, marketing services, and B2C campaign execution. Whether your credit union is looking to expand its offerings, build a legacy of community involvement, create the strongest possible capital footing—or all of the above—Advisors Plus consultants bring the strategic vision, deep industry expertise, and proprietary data analytics needed to help credit unions better serve their members and their communities. For more information, visit advisorsplus.com.