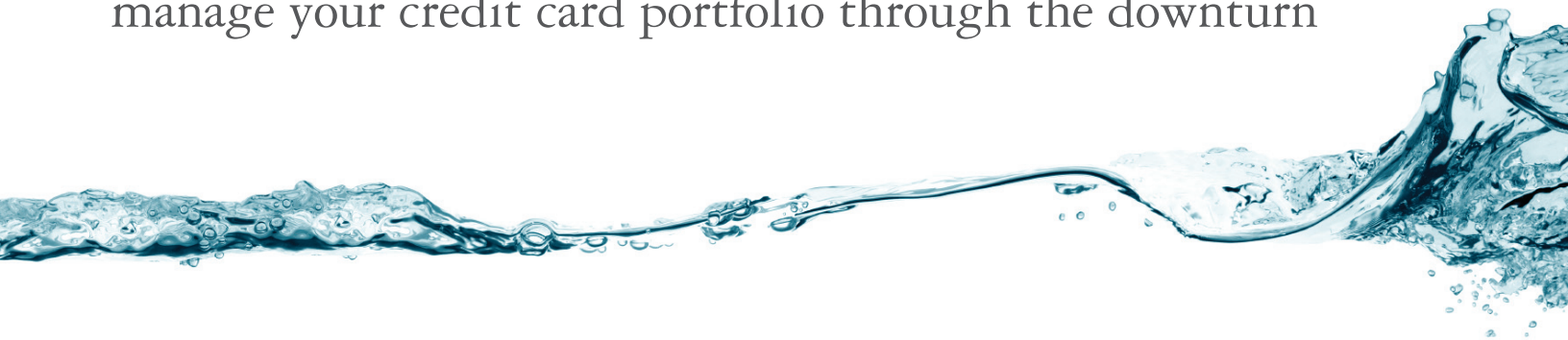




# Uncharted waters for credit card issuers

Managing your business in volatile times: 8 ideas to help manage your credit card portfolio through the downturn



If you think Canadian credit card providers are immune to the global credit crunch, think again. The credit card marketplace is under unprecedented stress, and Canadian issuers could see losses similar to those of their U.S. counterparts. Thus monitoring cardholder credit quality is more critical than ever. Many companies loosened standards in recent years – and many will suffer higher credit losses in the months ahead. To protect your bottom line, make sure you're managing your portfolio proactively and aggressively.

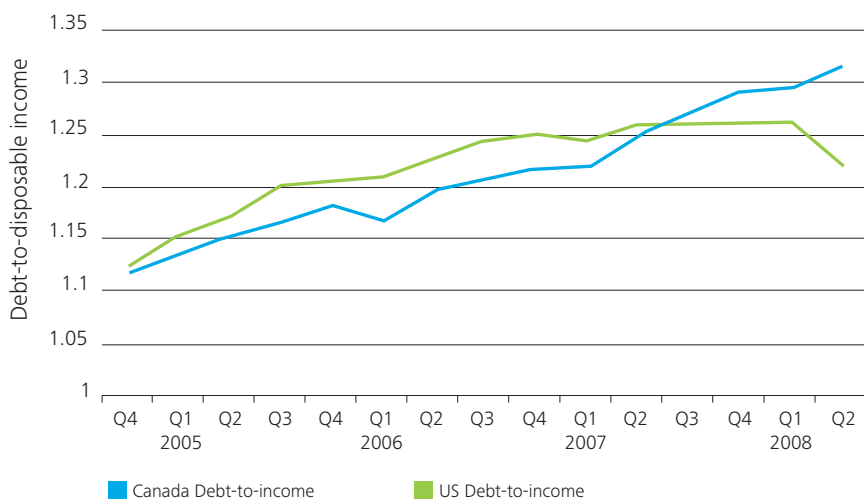
Deloitte recently interviewed management at major card issuers in Canada. The results were sobering. Most executives said that beginning in October/November of 2008 they started seeing a jump in delinquencies of 5 to 10 percent – which have increasingly been translating into write-offs. The result has been an uptick in losses of 50-100 bps. At the upper end of this range, this represents annualized losses of over \$800 million to the industry as a whole.

Some institutions have reacted to these risks by tightening credit standards for new accounts, implementing credit limit decreases for select accounts, and slowing down acquisition programs, particularly Balance Transfers. Nevertheless overall balances for most issuers are staying level or increasing. Many issuers have also instituted frequent credit score reviews of existing accounts to monitor for credit score “drift.” Most have not seen any appreciable increase in cash advances – yet.

Institutions that have multiple lending relationships with cardholders are viewing credit card losses as the “canary in the coal mine” with respect to credit issues. Customers will likely default first on cards rather than on mortgages or car payments. This is converse to what has been happening in the U.S. where fairly lax mortgage default legislation has meant that people have been walking away from their houses before they have missed payments on their credit cards. Thus, an increase in card losses portends an increase in overall lending losses.

Credit card issuers in Canada have traditionally seen loss rates of less than 4% – a figure much lower than that of their American counterparts (6% and growing)<sup>1</sup>. But with Canadian consumers increasing their debt-to-disposable-income ratios to more than 130%, a rate currently higher than that of the U.S., Canadian issuers face new risks. Since 2004, Canadian banks have seen their credit card balances increase by almost 40%.<sup>2</sup> Lenders must take action immediately to avoid the costly write-downs now common in the U.S.

**Debt-to-disposable income for Canada and US** <sup>3</sup>



<sup>1</sup> Source: DBRS, July 2008

<sup>2</sup> Source: Bank of Canada

<sup>3</sup> Source: Bank of Canada, U.S. Federal Reserve

Credit card issuers have experience navigating through the choppy seas of recession. But this one is different – we’re moving into uncharted economic waters. Traditional forecasting and risk management approaches used by Canadian issuers are likely to fall short in helping to manage the bottom line and maintain valued customer relationships. Methods, techniques, and models that worked well before might not be good enough this time. To tackle the problem effectively, you need to know all of your options. Here are eight useful practices and strategies to consider:

### 1. Upgrade your approach to forecasting with scenario planning

Traditional forecasting models based on historical patterns are proving unreliable predictors of future risks. You may need a more comprehensive approach that injects advanced scenario planning into your decision-making. Since the future is inherently uncertain, particularly now, scenario planning allows you to examine a number of possible future outcomes and to develop appropriate responses. For example, the depth of the recession is uncertain and there are potential regulatory changes on the horizon. Do your planning models currently incorporate these possible changes and how they will impact your business? Other areas of uncertainty may include customer use of other forms of payment such as debit or cash or competitors entering or exiting the market. By considering a number of possible outcomes and how you can respond will position you to succeed in the marketplace that emerges from this current turmoil.

### 2. Actively review the credit quality of existing customers

Circumstances for cardholders are changing quickly; customers who had impeccable credit scores six months ago may be in trouble today. Increase the frequency of reviews to identify accounts with deteriorating credit quality – and deal with them accordingly. You may want to consider closing inactive accounts where there has been a deterioration of the credit score in addition to reducing the credit limits on active accounts showing similar issues.

### 3. Monitor cash advances and credit line usage

Cash advances may indicate that a cardholder is in financial difficulty. Create a watch-list of accounts with unusually high cash-advance activity – and manage them continually. Also, there is a high correlation between the percentage of the credit line being used and the likelihood of default. Monitor accounts with high utilization as an early warning for troubled cardholders. When you do encounter accounts that may be in trouble review the other lending relationships that the cardholder may have with your institution to assess your full exposure. Taking a holistic view of the cardholder and their relationship with your institution is even more important in these times.

#### 4. Stop or reduce automatic credit limit increases

Consider putting a temporary halt to automatic limit increases until you have time to make adjustments to your credit scoring models. Credit limit increase requests should be vetted by underwriters who can incorporate the most current information into the credit decision-making process. Don't depend too heavily on automated models that may not capture recent changes in the financial environment. An overreliance on models is what partly precipitated this crisis.

#### 5. Intervene quickly when accounts become delinquent

Speed up the time it takes to contact customers who may be in trouble. Some issuers have seen collection calls increase by as much as 50%. Other issuers are starting to make contact soon after missed payments (if the credit score is declining) to understand the situation and work with the customer before the situation deteriorates. Early and proactive management can keep at-risk accounts from ultimately defaulting.

#### 6. Give customers a helping hand

These economic times create opportunities to build even stronger relationships with your customers. There are a number of actions you can take to help customers through their difficult times – actions that can build loyalty over the long term. For example, encourage customers to use automatic withdrawal options for credit card payments. This will cut down on delinquencies and create goodwill among customers who will avoid late charges. Provide customers with budgeting tools or tips that help them take control of their balances – especially right after the holidays. Reward those customers who pay bills on time by offering them loyalty points or reducing their interest rates. Systems that enable these actions already exist, but if you don't have a system that can manage this kind of customer-focused relationship building, make sure it's on your wish list. In this way you can build customer loyalty that will pay off for both consumers and issuers.

#### 7. Monitor fraud aggressively

While credit losses increase, negatively impacting the bottom line, fraud levels also tend to increase in downturns as more individuals find themselves in financial predicaments. Be on the lookout for suspicious activities and act to close any potential security flaws. Consider implementing new technologies that improve card security. You should advise merchants of the incentives for them to participate in "Verified by Visa" ("VbV") and "Secure Code" by MasterCard. Merchants can be protected from chargebacks, if the transaction has been validated through VbV. This will help reduce online fraud significantly for "card not present" transactions. Other strategies such as two factor authentication can also be deployed. You can also advise or require cardholders to inform you, when they are travelling outside of the country so that the transactions can be monitored. Review chargeback processing to ensure that fraud is not concealed in that process.

#### 8. Adjust your costs to reflect current realities

When top-line growth is difficult, everyone will need to tighten their belts. Put non-essential investments on hold and review your expense budget for opportunities to eliminate discretionary spending. Take a strategic look at all expenses and identify opportunities for savings. These could take the form of examining existing processes and policies – eliminating the "we've always done it that way" or optimizing your organization. An example of such an approach would be to review your current chargeback processes for opportunities to streamline and optimize to take advantage of the savings stemming from the significant changes taking effect with the Chip and Pin related liability shift in 2010. There may also be opportunities to reduce your spending by rationalizing vendors, renegotiating contracts or exploring R&D tax credits for new product development.

Institutions that take a "business as usual" approach to managing credit card portfolio risk will likely find themselves over-exposed and operating at a competitive disadvantage in the months ahead. These are uncharted waters – and extra vigilance is called for. The 8 ideas outlined here, if acted upon quickly, can help issuers to navigate uncharted waters.

## We're here to help if you need us

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