Ten key credit risk & lending challenges

Facing the financial services industry in 2017
Americas’ FS Regulatory Center of Excellence

The new year finds the financial services industry reassessing the impact of prospective changes due to regulatory uncertainty, balanced with optimism driven by new operational opportunities. The incoming administration has introduced the possibility of significant shifts in the regulatory landscape while, at the same time, technology is poised to take on a prominent role in lending and credit functions going forward.

The most significant external factors currently impacting credit and lending functions include a new accounting standard (current expected credit loss [CECL]) that could substantially impact the loss reserves for assets carried at amortized cost for many institutions, customer desire for a more streamlined service model, digital capabilities driving new levels of automation, and the prospect of being able to harness credit data and analytics in new ways to enhance all aspects of lending. Advances in cognitive computing, sophisticated modeling, and many other areas are changing the way that banks and other corporations do business, with organizations across the country and around the world looking to leverage the power of automation to optimize their credit processes, workflows, and resource utilization.

There are vast opportunities for cost reduction, increased transaction efficiency, and improved customer satisfaction from applying advanced technology to lending and credit operations. The following are just a few examples of where those opportunities exist:

— In the fourth quarter of 2015, the Mortgage Bankers Association reported that the net cost to originate had reached $6,163 per loan, up from $5,372 in the first quarter of 2015, due largely to the TILA-RESPA Integrated Disclosure rule going into effect in August 2015.

— According to the Origination Insight Report released by Ellie Mae, the average time to close a loan had increased to 51 days as of January 2017, continuing an overall upward trend of 10 months and marking the highest average in more than two years.

— The J.D. Power 2016 U.S. Consumer Financing Satisfaction Study reported that customers who were highly satisfied with their auto lending experience—based on features like accessibility of online bill pay and promptness of issue resolution—were more than twice as likely to lease or purchase the same brand again than were less satisfied customers.

Over the next few pages, we will highlight 10 key credit and lending areas that are likely to be top of mind for management and board members at financial services institutions in the coming year.
1. Preparing for CECL implementation

The new CECL standard will require institutions to significantly change their approach for estimating credit losses. Therefore, even though the effective date for CECL is more than two years away (January 2020 for SEC filers, January 2021 for non-SEC filers, and early adoption available in January 2019 for all filers), it is recommended that institutions begin acting now to prepare for the new accounting guidance.

CECL is the response by the Financial Accounting Standards Board (FASB) to the 2008 credit crisis, which exposed limitations in the incurred loss model that is used to reserve for credit losses. Under current GAAP, institutions are prohibited from looking ahead to reserve for events that have not yet occurred, thus delaying credit loss recognition.

Under CECL, however, institutions will need to estimate and recognize allowances for expected credit losses for assets measured at amortized cost, with the credit losses recognized immediately through earnings after those assets have been originated or purchased. In-scope assets will include held-to-maturity loans and debt securities, reinsurance receivables, and other receivables, regardless of their level of credit risk. Institutions must also recognize liabilities for off-balance-sheet credit exposures that are not accounted for as insurance contracts or at fair value, including financial guarantee contracts and any unfunded loan commitments that are not unconditionally cancelable.

CECL implementation will have a significant impact on data capture, operations, technology, and business processes within organizations. Depending on the extent of current credit risk modeling infrastructure, existing models may need to be modified to calculate and forecast expected credit losses, new CECL models may need to be developed or purchased to supplement/replace those existing models, or some combination of these approaches may need to be employed. Institutions may have to develop more granular sets of lending, financial, and economic data and more robust ways to precisely estimate and forecast their credit exposure.

Companies should begin evaluating their current level of CECL readiness by performing the following steps:

— Developing project management structure, including project management office (PMO), project plan, and a project steering committee
— Identifying changes to disclosure requirements
— Evaluating the existing chart of accounts and recommending revisions
— Assessing effectiveness of controls
— Assessing data and model readiness
— Assessing quantitative impact of CECL transition
— Performing requirements gap analysis and process evaluation.

Although two years seems like a long time to prepare for the transition to CECL, there is a lot that institutions need to do in order to be ready, as illustrated by the above list. Institutions that begin preparing sooner rather than later will be on strong footing when CECL takes effect.
2. Transforming lending operations

A mix of changing customer expectations, steadily rising costs, and emerging marketplace disruptors are combining to create tremendous profitability pressure for retail lenders. In the face of eroding margins, lending operations are being asked to transform their operating models to be more productive, nimble, and scalable than ever.

Retail lenders—particularly those in the mid-size and large categories—are combining multiple strategic transformation levers across origination, servicing, and default functions to create innovative programs designed to move them rapidly up the operational maturity curve. Those levers include the following:

— **Modernizing operational capabilities** – Deploying technology tools—including eDocs, eSignature, eClosing, mobile apps, and other solutions—to meet growing client expectations around the digital experience

— **Defining LEAN processes** – Consolidating existing workstreams where possible to drive greater efficiency and raise the bar on quality; for example, some lenders are integrating their first mortgage and home equity operations to gain economies of scale and provide a more seamless experience for clients with multiple loan products

— **Automation** – The ability of digital labor to significantly increase profitability and quality while also laying the foundation for future data monetization opportunities makes it a critical part of the transformation journey for any lender

— **Replacing core systems** – Executing core platform replacements to capitalize on the greater business agility offered by the latest technology solutions, improve operational efficiency, facilitate digital client experience enablement, and streamline regulatory compliance

— **Deploying the right operating model** – It is important for institutions to consider economies of scale and labor arbitrage when planning their future operating model, including leveraging digital labor wherever possible.

In addition, below are a few recommendations we have compiled based on our experience in leading successful operational transformation efforts for numerous retail lending clients over the past few years:

— Begin by establishing a clear perspective on the needs of your clients so that operational requirements are tied to enabling the desired client experience

— Dedicate adequate effort and resources to evaluating relevant operating model decisions in order to be able to communicate the rationale for critical strategic direction to stakeholders and ensure alignment

— Consider deploying a single platform to support first mortgage and home equity functions as it can lower operational costs, provide greater flexibility, and ease regulatory and compliance adherence

— Establish a dedicated, experienced PMO function. Exceptional governance, ability to address and implement challenging decisions, rigorous attention to change control, and stakeholder management are vital components for any transformation effort, all of which are spearheaded by a strong PMO.

The road to a successful lending operations transformation is built on the established fundamentals of process and delivery excellence and operating model design, powered by a new wave of innovative technological capabilities. The best performing lending operations will be those that are able to fully and successfully embrace digital enablement and robotic process automation, achieving a level of operational maturity that has never before been seen in the retail lending industry.
With technology ever advancing, the streamlining of credit data processes and infrastructure remains among the top priorities for many financial institutions in 2017. Though consumer lending encompasses numerous asset classes—mortgages, auto loans, student loans, credit cards, unsecured installment, and many more—the one constant is the importance of credit data. When properly organized, analyzed, and managed, data provides management with valuable insight into their business.

The significance of data is clear across each stage of the credit life cycle:

— **Customer targeting, segmentation, and pricing**
  - Account data can be efficiently organized and used to identify unique borrower characteristics and behavior patterns in order to recognize desired customer profiles, develop targeted products, establish risk-based pricing, and customize account services, a targeted approach that helps to optimize revenue through managing expected outcomes. Application and account performance data can be further augmented with external data—including information from credit bureaus and sources identified in the Consumer Financial Protection Bureau’s (CFPB) List of Consumer Reporting Companies—to more accurately target expected borrower performance.

— **Application**
  - Given the current competitive expansion into nontraditional lending, loan applications are being designed and used to capture critical data to assist lenders in underwriting borrowers, especially those with thin or nonexistent bureau data.

— **Underwriting**
  - A combination of credit bureau, external, and application information can be embedded in decision tree/machine learning frameworks and enhanced scorecards to help make yes/no decisions and determine the most appropriate loan structure(s) for each applicant.

— **Portfolio management**
  - Lenders have the opportunity to leverage a rich data source in their existing account application and performance data to tell the “story” of their portfolios and to track and manage expected outcomes. Accounts can be analyzed and promotions developed to maximize the effectiveness of loan products and services.

— **Collections**
  - Borrower underwriting, performance, and repayment behavior metrics can be aggregated into targeted data facilities in order to build behavior scorecards and construct and optimize collection strategies.

Through each step of the credit life cycle, data can be used to build reports and analyses that provide critical insight into credit operations and allow for the timely identification and remediation of any issues that may arise. Besides improving everyday credit data applications, effective analyses help management to refine and enhance their lending policies and procedures, paving the way for optimizing the overall risk management framework of the institution.
Almost six years after the issuance of the foundational model risk management (MRM) regulatory guidelines, MRM practices at financial institutions are evolving at a rapid pace. As the business environment and regulatory requirements change, financial institutions trying to achieve a target state for their MRM program have found themselves aiming at a constantly moving target. Heads of MRM programs at major institutions are currently facing a number of common issues, including:

— **Optimally defining a “model”** – Although regulatory guidance provides a general definition of a model, financial institutions have latitude in determining how they apply that definition in practice. Banks are adjusting their classification criteria in order to strike a balance between conservatism and operational burden, recently shifting to more inclusive model definitions.

— **Improving consistency of model risk ratings** – In the past, model risk ratings lacked the consistency to provide a reliable and accurate view of the materiality of model risks across business units, functional areas, and model types. Institutions are now working to improve and standardize ratings through peer reviews and other methods for establishing comparability between models. Nonetheless, further improvement is needed before risk ratings can become a robust tool for quantifying model risk at both the individual model level and at the aggregate, enterprise level.

— **Implementing a consistent IT platform** – Many financial institutions lack a single IT platform for their model development groups, posing a challenge for aggregating model results and reporting. Integrated quantitative platforms (IQPs) have been introduced at some of the largest banks in order to address this gap, a practice that is likely to become more common at a wider range of institutions in the future.

— **Fostering an MRM culture** – Institutions are looking to embed MRM within the culture of business lines where model development responsibilities reside. To accelerate this effort, results of “first line” MRM processes are more commonly being used as factors in performance reviews and compensation decisions.

— **Enhancing efficiency** – MRM is an expensive, labor-intensive exercise that institutions are always seeking to streamline while still maintaining their effectiveness at limiting risks. For example, rather than simply increasing model validation frequency and rigor, banks are working to improve their ongoing monitoring programs to proactively detect model issues. Specifically, institutions want to pinpoint models that require more validation resources while reducing unnecessary validation costs on models that consistently perform well.
5. Streamlining the credit rating process using cognitive technology

The institutional processes and framework around assigning credit portfolio risk ratings continue to attract significant attention within the capital markets space among financial institutions and their regulators and auditors. To help ensure that increasing regulatory scrutiny and internal risk management directives are met, the consistent monitoring, modeling, and measurement of credit risk across different segments of the lending portfolio are vital. Although enhancements to organizational credit risk capabilities have typically meant a significant capital outlay for additional staffing, outsourcing, technology, or some combination of the three, automation—or “cognitive technology”—now has the power to help institutions rein in costs while building a more robust and sustainable credit rating infrastructure.

The deployment of cognitive technology is allowing financial institutions to improve and more efficiently identify risk on an expanding scale. Cognitive technology continually acquires knowledge and, as it learns, becomes capable of anticipating new problems and modeling approaches. Some examples of areas where cognitive technology can be applied to streamline credit rating workstreams include:

— **Grading** – Current methodology for assigning credit risk ratings is limited by the need for a human to pull data from a credit file, understand the information it contains, and apply it against a loan grading scale. In the future, cognitive technology will be able to seamlessly extract, interpret, and weight file data in a fraction of that time, rapidly translating information into a loan rating.

— **Consumer credit rating assessments** – Historically, risk rating assessments have been done through sampling, covering a sufficient subset to satisfy regulatory requirements but still fit within the logistical capacity of the institution. However, cognitive technology can now exponentially expand loan sample sizes and, due to the homogeneity of risk data in many consumer loan portfolios, modeling can be applied to vastly improve the accuracy of assessments and provide better predictions of potential stressors and migration patterns.

— **Commercial and other nonhomogeneous portfolio credit rating assessments** – Validation of commercial and nonhomogeneous risk grading is based on a high level of judgment regarding the numerous credit factors that contribute to perceived risk rating accuracy. But using data mining, pattern recognition, and natural language processing (NLP), cognitive systems can simulate human thought processes and apply judgment useful in interpreting data and qualitative processes prevalent in nonhomogeneous portfolios.

— **Reporting and analysis** – Increased reporting capabilities made possible by automation will allow for enhanced dashboard reporting, drill-down functionality, and segmentation analysis (e.g., geography, line of business, segment, etc.). Cognitive technology can also incorporate external data sources—industry, macroeconomic, and unstructured—to facilitate analysis across portfolios, identify anomalies, and prioritize results to help ensure that investigations focus on areas with the greatest risk.

With cognitive technology still evolving, there will be challenges for institutions to clear during this transition period. Large volumes of data are required to facilitate effective machine learning and deploying complex risk-grading models will require an initial investment in resources, time, and cost. However, the advantages of credit risk automation—as detailed in the preceding bullets—suggest that the use of cognitive technology should continue to steadily increase in financial institutions across the country and around the globe.
6. Leveraging targeted client marketing to employ precision lending practices

With ever-growing pools of credit data and incremental increases in the power of algorithms and computing infrastructure, institutions are now able to go beyond just forecasting trends at the segment or cohort level and predict the behavior of individual customers. In the Fintech sector, predictive behavioral analytics, machine learning, and data-driven assessments are changing the way that banks and emerging lending platforms operate. Collectively, these advances have spurred the development of sophisticated client targeting and product customization techniques, allowing financial products to be tailored and marketed to specific borrowers through “precision lending.”

Though precision lending models can be used to identify customers across a broad swath of loan products, one common application has been to help banks target candidates for the First-Time Home Buyers (FTHB) program. Identifying prospective FTHB borrowers can be challenging because they are generally not as credit-active as other consumers and can therefore be “hidden.” However, by employing machine-learning algorithms such as information gain theory, neural networks, random forests, and support vector machines, institutions can locate potential FTHB borrowers using precise lending models that sift through large third-party credit, insurance, and social media data sets in order to analyze temporal features like account balance fluctuations.

It is important to help ensure that any precision lending models being deployed are able to withstand regulatory scrutiny. Institutions should document all decisions made around their model design and inputs while avoiding the use of biased datasets for training and testing their model algorithms. In addition, it is recommended that lenders post-test their precision lending models for regulatory compliance. Collectively, these measures can help practitioners stay within regulatory guidelines while harnessing the potential marketing benefits of precision lending methodologies.
Financial institutions are expanding their control functions to meet regulatory requirements and effectively mitigate risks within lending and credit areas. However, these functions rely heavily on inefficient manual processes to perform controls testing and monitoring. Financial institutions, therefore, must dedicate significant effort to extracting, transcribing, and reviewing credit information obtained from documents and systems of record.

Controls testing is typically performed long after an event has occurred, has a slow turnaround time and limited opportunity for scalability, and creates an unsustainable cost structure. These inefficiencies make it difficult or impossible to perform a thorough analysis of the results, limiting the ability of management to gain relevant insight into the overall credit risk profile of the organization.

To counter these challenges, financial institutions are capitalizing on advanced data and analytics capabilities to automate credit control frameworks through all three lines of defense. Optimizing and automating control processes is performed through mixing big data and cognitive computing (i.e., machine learning and NLP) with traditional automation and business process improvement techniques. Effective automation sets the foundation for the continuous monitoring of controls defects within the lending and credit areas while standardizing procedures and fortifying the quality function.

The following are examples of typical areas where the automation of controls testing and monitoring is being used:

— **First-line quality control (QC) processes** – Automation is especially useful for reviewing data and documentation associated with QC processes, particularly when a high volume of judgmental analysis is needed to examine policies or other complex documents containing unstructured text.

— **Second- and third-line review processes** – Departments such as credit, compliance, legal, risk management, and internal audit can streamline their review and analysis of both structured and unstructured data and documentation, saving time and reducing costs.

— **Call center and customer service** – Functions like call monitoring and feedback reviews can be automated to help identify the root causes of customer feedback and complaints more quickly and effectively.

Automating key aspects of controls testing and monitoring can help financial institutions quickly and efficiently gain insight into both structured and unstructured credit data, ultimately leading to better lending decisions.
Using risk data aggregation and reporting for improved enterprise risk management and transparency

Risk data aggregation issues continue to garner increased attention:

— In 2016, financial regulators stepped up pressure on financial institutions to enhance their data-related systems and processes. Growing regulatory concerns over counterparty credit risk and credit risk concentrations have further underscored these efforts.

— With the January 2016 deadline for compliance with Basel Committee on Banking Supervision (BCBS) principles having already passed, the Office of the Comptroller of the Currency (OCC) is expecting financial institutions—especially the largest organizations—to be compliant with the BCBS principles for risk data aggregation.

— CFOs for most banks subject to Comprehensive Capital Analysis and Review (CCAR) requirements are now under pressure due to the CFO Attestation mandate that places an emphasis on a “materiality” requirement. As a result, items like enhanced process controls, data tracing, and single-sourcing of data figure to remain areas of focus for the C-suite moving forward.

— Many of our banking clients have indicated that data-related issues are becoming more prevalent in the latest matters requiring attention (MRA) and matters requiring immediate attention (MRIA) they are receiving around Federal Reserve requirements.

— We are also seeing clients placing increasing emphasis on the importance of mapping to authorized data sources for financial and nonfinancial regulatory reporting purposes.

Data governance and quality are becoming strategic initiatives for executives and boards seeking to establish an integrated framework to drive data process enhancements across their enterprise. Reconciling finance and risk data into unified data sets facilitates better internal decision making, improved operating efficiency, increased accuracy in stress testing and capital allocation, and more streamlined regulatory reporting. It also helps to shed light on the strengths and weaknesses of risk management activities within the organization.

Financial institutions may have difficulty in building the solutions necessary to manage this data and its associated risks. Such systems should be able to identify, aggregate, and monitor gross exposures within the institution and across the industry.

Ultimately, the overarching objective is to create a foundation for unlocking the value of data. Evolving technologies are making it possible to integrate contextual data and machine learning to dynamically assess populations of structured and unstructured data sets. These breakthroughs can provide institutions with the information they need to guide operating and business strategies, both now and in the future.

---

1 OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of 12 CFR Parts 30 and 170

2 Office of Management and Budget (OMB) Supporting Statement for the Capital Assessments and Stress Testing Information Collection (FR Y-14A/Q/M; OMB No. 7100-0341)
9. Implementing credit policy governance

In response to an improving economy, financial institutions have significantly expanded the scope and complexity of their loan products. The added offerings are largely designed to attract new customers and better compete with alternative lending channels like Fintech. These new products have prompted some significant operational changes, including the development of additional processes to support them. However, in many cases institutional credit policies and procedures have not been updated to reflect those changes. As a result, increased regulatory guidance around policy expectations—combined with horizontal compliance reviews—have exposed deficiencies in the credit policies of many financial institutions.

When designing, implementing, or updating credit policies to address operational changes, financial institutions should consider the following practices:

— Aligning credit policies with the overall risk appetite and risk strategy of the organization
— Structuring credit policies within established policy frameworks
— Building and documenting a credit policy governance structure
— Clearly defining the exception escalation and approval process
— Creating a concise inventory of all credit policies, including the owner and location of each policy
— Linking credit policies to each part of the credit life cycle to provide a consistent credit risk management philosophy across all lines of business
— Ensuring that credit policies are vetted and approved by senior management to foster proper leadership engagement and meet regulatory expectations around sound risk management practices.

Well-defined credit policies with clear accountability support the overall credit strategy of the organization, setting guidelines for acceptable credit risk tolerances and leading to uniform credit risk management across all business lines and products.
Consumer complaints regarding the accuracy and use of credit data by financial services institutions are on the rise. This surge in complaints has been attributed to several factors, including:

— The impact of historic loss mitigation practices being incorrectly reported to the credit reporting agencies (CRAs)

— Lost or misplaced customer information due to issues with the hasty servicing system data migrations that have resulted from industry consolidation

— Insufficient controls and oversight over credit data management

— The emergence of new lenders from Fintech and other sectors where there is a lack of regulatory perspective on the permissible use and furnishing of credit data.

In light of such issues, state and federal agencies like the CFPB3 and Federal Trade Commission (FTC)4 have recently heightened their scrutiny of consumer credit reporting accuracy and integrity. More specifically, the CFPB and FTC have targeted operational processes and activities that could lead to incorrect data reporting and potential consumer protection concerns. Over the past five years, these agencies have released new guidance and investigated business practices of CRAs and data furnishers like banks, credit card companies, and other financial services institutions. Where infractions have been identified, regulators have taken enforcement actions like imposing hefty fines and other penalties.

Consumer credit reporting issues took center stage last year when it was discovered that employees at a major U.S. bank had secretly opened more than 2 million bank and credit card accounts in the names of their customers without the knowledge and consent of those individuals. In some cases, the credit scores of impacted consumers may have been adversely affected in the form of credit denials, higher interest rates, and other repercussions. Not surprisingly, this incident has fueled a subsequent rise in operational risk reviews, regulatory complaints, and litigation.

Though it can be difficult to pinpoint practices that carry the potential for data errors and resulting customer harm, organizations should be aware of these risks and build a robust controls framework around their credit reporting operations to prevent them. Some specific measures to consider would include:

— Making enhancements to existing procedures to more explicitly specify required reporting codes and standards

— Implementing additional quality assurance processes

— Deploying new technology to continuously monitor for data errors.

Beyond these steps, periodic self-assessments are strongly recommended to help ensure that credit reporting continues to align with regulatory demands and customer expectations on an ongoing basis.

