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VIEWPOINT

Coping with New Credit Risk Realities

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A decade ago it was virtually impossible to get banks to take the risks of consumer lending seriously. Amid seemingly insatiable risk appetites in the global capital markets and falling underwriting and pricing standards, banks began building substantial portfolios of mortgages, home equity loans, credit cards and auto loans.

"Creative financing" and "new paradigm" were uttered on various squawk boxes with predictable regularity. Consumers gobbled up banks' relentless credit offerings and spent in record fashion to sustain their participation in a waning American Dream.

Efforts to raise alarms — including mine, as deputy comptroller of credit risk at the Office of the Comptroller of the Currency — did not compel change. "No bank ever failed because of consumer credit problems" was an oft-repeated bromide. Supervisors, fearful of criticism that constraining credit would hurt the economy, were reluctant to act.

It was widely assumed that banks could nimbly measure and manage consumer credit risk based on the richness of data, the power and predictability of consumer credit risk models, the laws of large numbers and the ability to price for, and lay off, risk.

Bankers are still calculating the costs of complacency: Trillions in losses, millions of foreclosures, thousands of lawsuits, hundreds of bank failures (with more to come), federal and state fiscal crises and severely damaged reputations with every meaningful constituency (customers, regulators, public esteem, Capitol Hill, etc.).

Predictably after the lending excesses of the past decade, the industry finds itself in the throes of an unprecedented wave of regulation and consumer protection. The settlement terms recently proposed to mortgage servicers by the state attorneys general have raised questions about the merits of this latest wave and whether it will lead to excesses of its own, but what's not debatable is that for the foreseeable future, consumer credit risks and issues will be fixed on the industry's radar screen. Some thoughts on navigating the environment:

- Supervisors should pay attention to, and act upon, their own early-warning tools. Poor risk selection and underwriting cannot be rationalized away without consequences. Beware "creative financing" and "new paradigms."
- Legislators should eliminate inherent conflicts between supervision and policy so that they can serve their intended checks-and- balances roles. Legislators and regulators should resist quick fixes for the housing market: Advocacy for foreclosure avoidance and modification is one thing; compulsory forbearance is another.
- Bankers should regularly measure where the markets are taking their lending and pricing standards and decide whether it is worth the trip. In doing so, they must embrace the fact that collateral is merely a precautionary supplement to a sound extension of credit, and is not designed to be a cure for bad lending decisions. In emphasizing repayment capacity, they will learn to resist lending to highly leveraged consumers. Stretching the last possible dollar of income available for debt service is a recipe for disaster financially and reputationally. When a highly leveraged business goes bad, few seem to care, but when a highly leveraged consumer defaults, the lender is frequently assigned the blame.
- Bad credits boomerang. Bankers attempting to sell their mistakes are likely to get them back.

- Bankers who price for risk must retain increased revenues in the form of reserves and capital, and not dividend them away or otherwise leverage them.

- The laws of large numbers speak to statistics and predictability. They are less relevant in deciding how to serve individuals fairly and appropriately. Also, models are only as good as the assumptions fed into them, and their use must be judiciously governed.

- Invest in robust risk management for consumer lending.

Bankers' attitudes toward their customers, and the risks they carry, must improve. Banks that navigate well through the next few years will commit to responsible lending, improved delivery and service, and strong risk management. Sales practices, know-your-customer, fairness and service will count.

Rational judgment must complement the efficiencies of the laws of large numbers. And bankers must avoid the lure of financing consumers that believe in an inalienable right to spend beyond their means.

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