EXECUTIVE INSIGHTS

COVID-19 Recovery Opportunities in Consumer Lending

The COVID-19 pandemic has ushered in a series of fundamental challenges to the U.S. economy. Like the great financial crisis of 2007-08, it has reshaped the landscape of consumer lending, but in a very different way. During the COVID-19 pandemic, individuals have curtailed their spending amid layoffs, while the federal government has injected billions of dollars back into the economy in the form of stimulus checks. Ecommerce was a key beneficiary, and it looks like newly established purchase pathways are here to stay.

In the meantime, lenders across the board have reconsidered their participation in consumer lending. Some, especially prime lenders, have significantly reduced their exposure by tightening their criteria for new lending — in some cases, even stopping new lending completely until a sense of normalcy returns.

The net result is that the pandemic has created substantial opportunities in consumer lending, both for new lenders looking to enter the market and for existing lenders looking to expand their footprint. As vaccines continue to be administered and businesses across the nation take steps toward reopening permanently, financial institutions and their investors can employ numerous strategies to make the most of those opportunities.

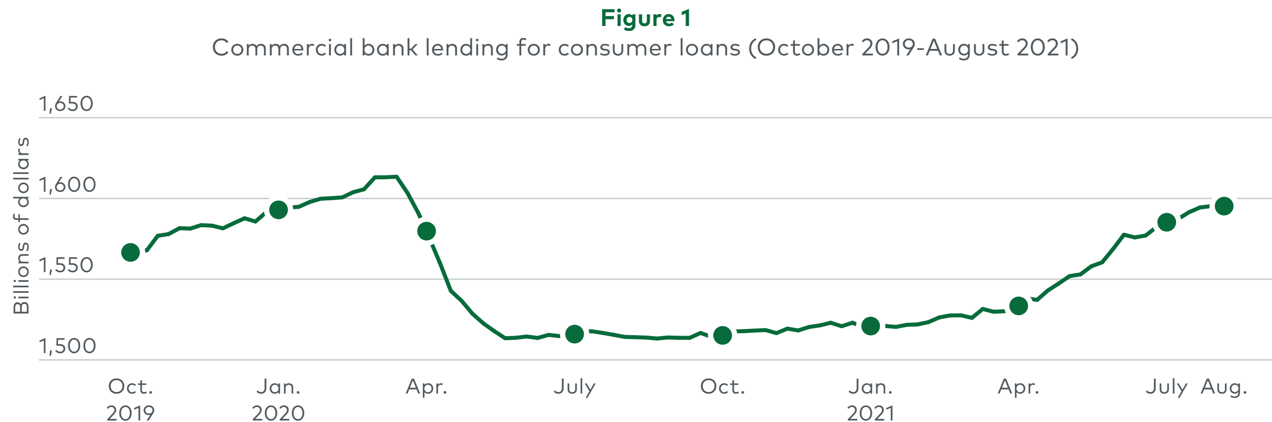
The impact of COVID-19 on consumer lending activity

The U.S. government has done a number of things to keep the economy running — and help consumers meet their loan obligations — in the face of COVID-19. In addition to the Coronavirus Aid, Relief and Economic Security (CARES) Act, the $2.2 trillion stimulus bill passed in March 2020 that included forbearance for many types of mortgages and most federal student loans, Congress has put in place fiscal relief provisions, including enhanced

unemployment insurance and the temporary exclusion of most forgiven student loan debt from taxation.

Those steps helped keep delinquency rates low in 2020. The economic disruption was most apparent in the second quarter of that year, as lending for unsecured credit products slowed dramatically (see Figure 1).

Figure 1
Commercial bank lending for consumer loans (October 2019-August 2021)



Note: Seasonally adjusted data covers all U.S. lending for commercial banks (both domestic and foreign)
Source: Board of Governors of Federal Reserve System

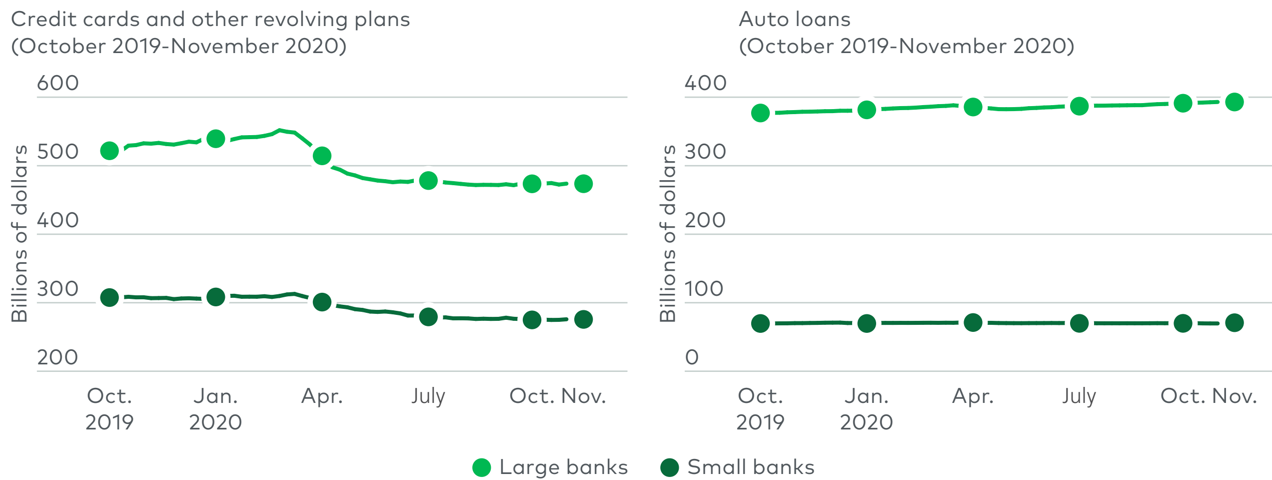
Access to credit cards and personal loans was expected to rebound through the first half of 2021 due to anticipated improvements in macroeconomic factors such as employment and GDP, but while some consumers may have overextended and will struggle with their monthly payments after government assistance programs end, many will seek loans again, sending their balances back up.

In 2020, credit card loans decreased at small and big banks alike, with large banks accounting for the lion's share of the volume decline. Auto loans, meanwhile, slowed during March and April 2020 but started to grow again in the second half of the year[1] as new and used vehicle sales resumed (see Figure 2).

Banks experienced weaker demand for consumer loans as customers displayed more conservative financial habits. Revolving balances fell — primarily due to people charging less to their credit cards — as consumers dialed back on discretionary spending, in particular for restaurants and nonessential shopping. In addition to spending less, consumers who secured cash from government stimulus programs used some of that money to pay off both credit card and existing loan balances.

While economic conditions have begun stabilizing recently, unemployment remains high relative to before the pandemic, which has prompted lenders across various industries to

Figure 2
Consumer lending by domestic banks



Note: Seasonally adjusted data covers all U.S. lending for domestic commercial banks; the vertical scales of the two panels are different, but the ranges are the same for the sake of comparing relative movement
Source: Board of Governors of Federal Reserve System

implement restrictions on lending. In the meantime, forbearance programs have changed the lending landscape as the programs make it difficult both to interpret credit-scoring data in underwriting and to collect on defaulted loans.

But as vaccines continue to be administered across the U.S., the hope is that the reopening of the country's businesses — together with the increased number of available jobs and higher wages — will improve consumers' ability to manage their debts in 2021 while also prompting them to increase their credit-card spending.

More new loans will go to lower-risk consumers as lenders put a greater emphasis on customers' repayment history and take a more conservative approach to assessing loan affordability, while many consumers who do get loans will be charged higher rates. However, lenders — especially unsecured lenders — will eventually need to reassess their lending criteria and increase their risk appetite to prevent their books from going into runoff and their incomes from falling to unsustainable levels.

The impact of COVID-19 on consumer lending innovation

The number of consumer borrowing options was already on the rise when COVID-19 hit, but the pandemic threw the technological innovations powering that growth into overdrive. Fintech lending platforms welcomed small-business owners who had previously been turned down by traditional banks, for example, and mobile apps offering easier, faster ways to borrow money streamlined the user experience.

While many big banks and legacy lenders have not yet learned from their fintech rivals, adopting emerging best practices[2] that came about as a result of COVID-19 could help them improve their performance in the interim. These practices include:

- Using data and psychometrics to assess creditworthiness
- Deploying accounting integration to provide invoice financing for short-term needs
- Harnessing artificial intelligence (AI) to transform lending into a long-term partnership
- Building ongoing relationships through a membership model

The pandemic has also acted as a catalyst for lenders to adopt new technologies to stay competitive. Consumer use of online channels and digital platforms has surged during the pandemic: 40% of consumers have been using digital channels more frequently, while 60% of consumers say they conduct the majority of their financial transactions on mobile applications. One in three consumers are now engaging with their preferred financial institution multiple times a week via digital channels, and roughly two out of every three consumers are utilizing such platforms a minimum of once a week. Financial institutions that have prioritized digital innovation to optimize their consumer interactions are likely to see the most upside over the long term.

Consumers' increased online channel/digital platform use means they can be receptive to receiving relevant credit offers that are tailored to their financial needs. Lenders subsequently need to continue investing in providing consumers with seamless engagement, underwriting and servicing experiences. Those lenders that customize every consumer touchpoint to enable a seamless experience will be the ones that win going forward.[3]

Point-of-sale (POS) lending, which enables consumers to make purchases with incremental payments,[4] also became a much more common option during the pandemic as consumers increased their online spending. Ecommerce merchants are prime candidates for offering these types of digital loans because the loans can be promoted to consumers before they get to checkout, which can increase the amount consumers spend on their purchases. Retailers then partner with third-party lenders (e.g., Affirm, Afterpay, Klarna) to integrate their services into the checkout process.

One reason for the popularity of POS installment loans offered through digital channels is that lenders have streamlined the application process, reducing the friction that consumers would otherwise find prohibitive. The ability to quickly access financing at a retailer's website, more flexible borrowing limits, no credit history requirements, and low- or no-interest options have all helped reduce the friction of borrowing.

Short- and long-term challenges in banking and lending caused by COVID-19

Many consumers have never faced unemployment or base interest rates at anything far above zero, which will challenge both the rates' affordability and consumer budgeting skills going forward. Lenders are facing corresponding tactical and strategic challenges that are being driven by changing customer behaviors, emerging technology and data sources, and increased competition and margin pressure due to new investments and capital in the industry.

For lenders, the challenges associated with COVID-19 will play out over the short and long terms.

Short-term challenges

These challenges include:

- High volume of forbearance requests from distressed customers in 2020
- Immediate impact of government initiatives in mortgages and unsecured lending on customer repayment behavior as well as lenders' ability to use more involved collection methods
- Inability to use normal working methods and a wide range of other operational difficulties as contingency plans are tested beyond what was, until recently, regarded as any reasonable expectation in terms of both depth and duration of the crisis

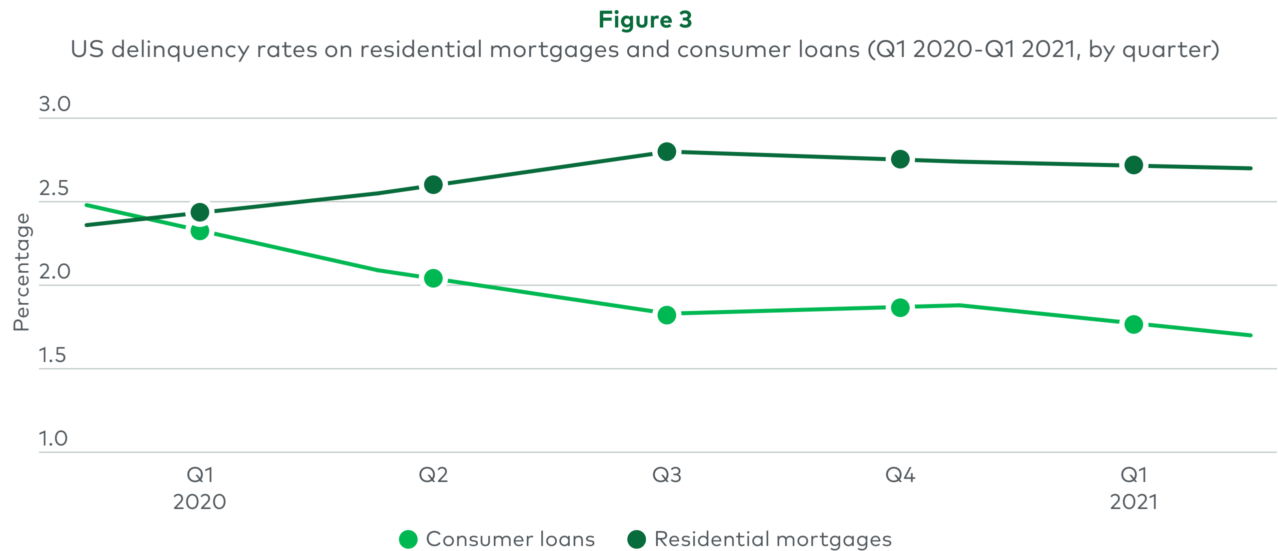
Long-term challenges

These challenges include:

- Short-term challenges (listed above) that persist beyond the immediate emergency period, fundamentally changing the lending and financial services landscape itself
- A resetting of assessments of creditworthiness to include lower and/or more volatile expectations around income and earnings
- Changes in customer behavior and, by extension, the ability to assess customers' creditworthiness (though funding availability will be less challenging than it was during the great financial crisis)

U.S. delinquencies increased during the great financial crisis at a higher rate than in other countries (e.g., United Kingdom), whereas during the COVID-19 pandemic, U.S. delinquencies have remained low. According to the Federal Reserve,[5] from the first quarter of 2020 through the first quarter of 2021, the average delinquency rate on residential mortgages was 2.64%; for consumer loans (credit cards, other), it was 1.99% (see Figure 3).

Figure 3
US delinquency rates on residential mortgages and consumer loans (Q1 2020-Q1 2021, by quarter)



Source: Board of Governors of Federal Reserve System

COVID-19 has prompted many prominent banks to moderate their appetites for mortgage lending. JPMorgan, U.S. Bank and Wells Fargo have all tightened their standards on home loans and suspended their home equity line of credit offerings, for example. Meanwhile, nonbank lenders — which now provide a majority of home loans — don't have access to Federal Reserve funds and so may not be able to absorb a flood of defaults. Notably, these actions run counter to the Federal Reserve's approach[6] of boosting liquidity at banks in order to promote lending.

Groups in the nonbank lending space, meanwhile, have experienced substantial margin calls throughout the pandemic. As a result, many of them have ceased lending altogether and are instead selling portfolios to raise cash that will allow them to continue in the business.

Key strategies lenders can take to successfully navigate the post-COVID-19 era

Lenders can use a variety of levers to create successful going-forward strategies. These strategies differ by bank type and lending class and include especially strong opportunities for specialist lenders and/or those with complex, data-driven underwriting capabilities.

Big banks. To help them capture the seven out of 10 Americans who say they would switch to a financial institution with more inclusive lending practices, big banks should use machine learning and big data tools to augment credit reports with real-time income or cash-flow data. They should also continue their accelerated shift to online channels, as all lenders will need to keep investing in seamless engagement, underwriting and servicing experiences. Large

financial institutions that prioritize digital innovation to optimize their consumer interactions are likely to see the most competitive upside over the long term.

Small banks. Against a backdrop of increased interest in lender trustworthiness; intuitive digital application processes; personal loans for new entrants; and self-serve, omnichannel digital lending experiences, small banks should position themselves to meet changing consumer demand.

Specialist lenders. To capture customers that the larger prime banks have turned away, specialist lenders should actively position and market themselves to newly nonprime borrowers. Specialist lenders should also continue to offer tailored solutions through open banking for those with complex and nontraditional financial needs. Doing so will help streamline the mortgage approval process; it will also help the specialist lending sector deliver tailored solutions to this growing segment of the market with greater speed and efficiency.

Subprime lenders. To meet the evolving preferences and needs of consumers, subprime lenders should also actively position and market themselves to customer groups that have been newly rejected by mainstream lenders. Subprime lenders could also offer POS financing as an alternative to credit cards. Presenting line of credit financing as personal loans to consumers who make frequent, small-dollar transactions will help combine the strengths of personal loans and credit cards to target initial consumer transactions. And to better assess customer risk profiles, subprime lenders should invest in automation, which will help remove any replicable rule-based process from humans by leveraging AI and machine learning, allowing lenders to scale up without the need for a corresponding increase in team size.

COVID-19 has prompted U.S. lenders across the board to reconsider their participation in consumer lending. And those lenders that remain have pulled back on new business volume as they try to determine:

- How secure their funding is and the level of volume it will support
- To what degree new lending should match up with the overall operating cost base of their business
- How to assess the creditworthiness of new customers
- How confident they are in both the performance of their back books and their cost expectations to allow for increased collection activities

Economic shocks and the downturns they yield also create opportunity, and COVID-19 is no different. And unlike in the great financial crisis, the federal government has provided a significant amount of fiscal relief to help consumers meet their loan obligations. Banks and

specialist lenders, and their investors, need to embrace strategies that make the most of their capabilities while directly addressing the needs — and evolving behaviors — of their target customers.

For more information, please contact finance@lek.com.

Endnotes

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