White Paper

Winning in the Next Era of Collections

Preparing collections for a recession

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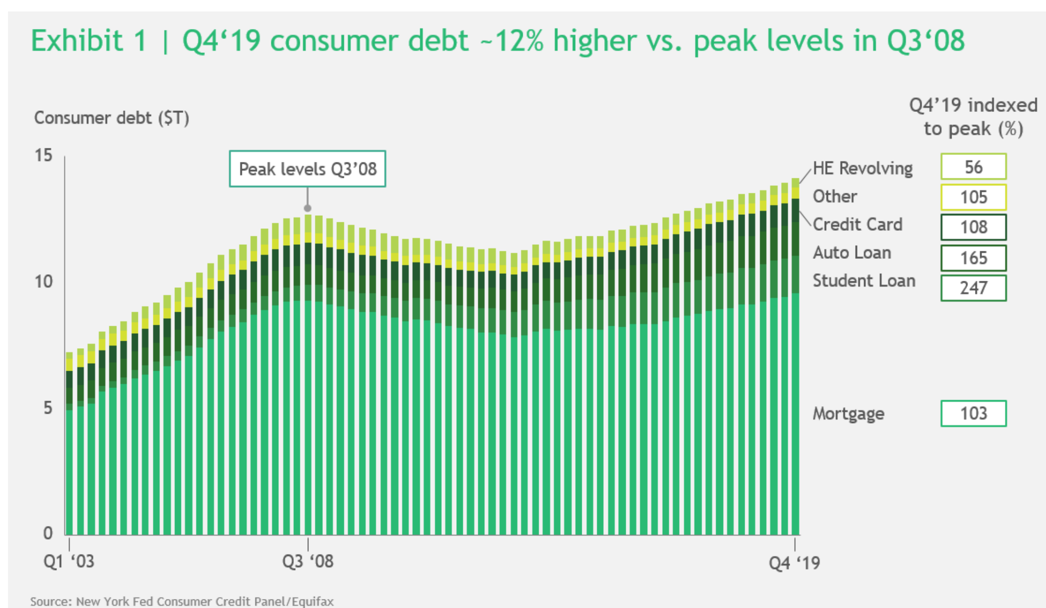
Since the 2007-2009 financial crisis, US consumer lending markets have been buoyed by healthy macroeconomic growth, low funding costs, and generally sturdy credit trends. While improved underwriting standards have contributed to the positive performance of lending markets, even the most confident credit department is likely to admit that the prevailing winds have been at its back.

There are several reasons to think that the next few years won't be as benign. While the US currently enjoys full employment, consumer indebtedness is also reaching levels not seen since the mid-2000s (see Exhibit 1.)



At time of writing, the global economy is in the midst of a full-blown crisis due to the COVID-19 which as of March 15 has precipitated a 150bp cut in the Fed Funds rate over last two weeks and an emergency aid package to lighten the load on consumers. The major stock indices are currently in full bear-market mode. Finally, it is an election year in the US, which usually introduces a degree of economic turbulence.

So, the economic headwinds of this year and beyond are likely to be considerably brisker than has been experienced for some time. While firms recognize, in theory, that collections (delinquency

management) and recoveries (default management) units will be essential in the next recession, we have found that these departments are usually not as ready for a downturn as they should be.

This paper shares insights into two broad questions:

1. What did the industry learn about collections and recoveries during the last recession, and are those lessons likely to be valid in the next downturn?
2. What tactics and procedures do FIs need to develop for a perhaps drastic increase in delinquencies?

A. *The Financial Crisis: Lessons and Application for Collections*

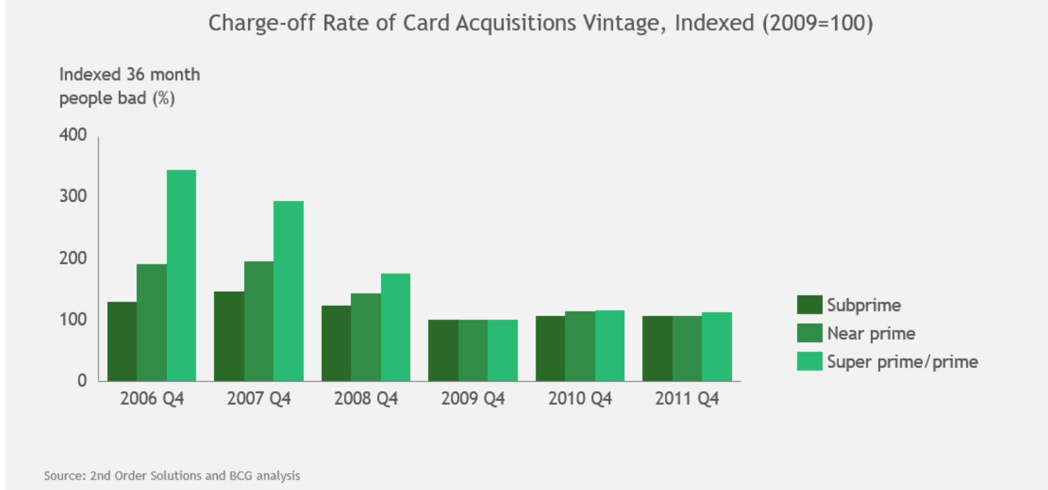
While the next recession will likely be different in terms of causes and specific consumer impacts, the lessons learned in the financial crisis of 2007-2009 remain instructive for FIs. Absorbing those lessons, alongside consideration of what might be different next time, will enable wise FIs to outperform peers when a slump does occur. What follows are several key collections and recoveries-related lessons from the Great Recession:

1./Many consumers found themselves in financial distress for the first time. Banks found themselves surprised by both the types of customers who defaulted and the regions in which they lived. Before the onset of the financial crisis, it had been over a dozen years since the last significant US downturn and many consumers experienced unemployment for the first time in their lives. This was even more acute for consumers in areas where home prices depreciated significantly and access to home equity was thus eliminated[1].

Variations in financial distress were not only experienced across geographies, but also across credit worthiness. Charge-off rates for sub-prime consumers in fact increased only moderately relative to pre-crash levels but, in contrast, there was a significantly higher rate of charge-off increase among consumers in the middle and upper ends of the credit spectrum (see Exhibit 2).

[1] Certain states highly dependent upon tourism and/or the housing market, (e.g., Florida, Nevada) were both quicker to feel the recession and later to recover (source: US Bureau of Labor statistics)

Exhibit 2 | Great Recession had significantly larger impacts on the Superprime population, Subprime population was impacted by ~30-50%



Source: 2nd Order Solutions and BCG analysis

These debts proved especially difficult to collect due to these customers' unusually high levels of indebtedness.

The FIs that coped best during the last recession quickly adapted to changed circumstances. They recalibrated their segmentation models to more efficiently target customers based on exposure, reason for delinquency, and likelihood to default. There was also new messaging and loan modification offers designed specifically for customers who were particularly likely to repay.

It's not easy to predict which consumer segments will be most affected by the next recession and by how much. FIs should recognize the probability that the profile of customers who miss payments may not align to their current expectations. Investment in granular portfolio monitoring to detect and understand these risk trends at an early stage is critical.

2./Faced with significant financial stress, consumers were selective in repaying their loans.
As the financial crisis began to hit in the US, many debtors prioritized some payments over others in an effort to manage multiple and competing financial commitments. For example, some chose to pay auto loans rather than mortgages or rent calculating - correctly - that foreclosure and eviction takes longer than automobile repossession. Similarly, debtors sometimes strategically defaulted on a set of credit cards while maintaining payments on a single card to enable non-discretionary spending. Maintenance of liquidity and short-term access to credit became primary

motivations for consumers, while minimizing interest payments and fees or protecting a high credit score became less important.

Creditors should be prepared for similar important shifts in debtor payment behavior during the next slump. Payment of some obligations, such as unsecured personal loans or credit cards with fully utilized credit lines, have less future utility for customers relative to other loans, and we should expect customers to act rationally in the face of financial stress.

3./Defaults mounted and volume surges were difficult to manage. More and more customers became delinquent as the recession progressed, and there was a dramatic reduction in debt curing - that is to say, debtors who missed initial payments were more likely to roll forward into later stages of delinquency. Flow rates worsened and collection inventories swelled to two or three times levels seen before the crisis. FIs were often unprepared for this explosion in collection workload, and when they found themselves under-staffed, few had any contingency plans to allocate stretched resources to the highest-exposure customer segments.

Management of collections departments quickly learned that reliance on third party suppliers also yielded poorer results than anticipated, largely because those suppliers faced competing demands for their services. This was a particular problem for smaller financial firms as suppliers typically allocated their scarce resources to larger, more lucrative, bank clients.

Furthermore, management discovered that efforts to rapidly hire and train new collectors resulted in lower-than-average performance and increases in compliance violations.

4./The poor performance of debt-sale strategy was an unwelcome surprise. Many creditors expected that selling debt would be a successful contingency plan, thinking it would both create an immediate financial inflow and also extra operational capacity. Instead, the industry experienced historically low debt sale prices during the crisis and greatly reduced demand for marketed portfolios.

Litigation strategies, meanwhile, generally performed well over the long term. However, while the resilience of litigation as a solution is encouraging to creditors, it is also relatively expensive and

can last for years. Litigation strategies are most successful when FIs track borrowers after the charge-off to better understand when legal strategies might have highest returns. However, to see full benefits from a litigation strategy, 1) FIs must have it in place at the outset of a recession to reach customers quickly; and 2) be prepared to see short-term negative impact as it will take months for a litigation strategy to run its course.

Today, large debt buyers have greater operating scale and are generally better capitalized now than they were during the 2007-2009 crisis. And although funding is less likely to be a constraint, recessionary forces will still drive down debt sales prices to reflect lower near-term repayment rates. We believe that while a well-designed debt sale strategy can be valuable during a downturn we would caution creditors to not place undue emphasis upon it.

5./ Telephone contact experienced diminishing success rates. As collection volume grew, creditors made increasingly persistent efforts to contact debtors by phone, but these efforts hit diminishing returns. It became increasingly easy for debtors to ignore phone calls, while consumers were using land lines much less than before and also enthusiastically embraced new call blocker technologies for the first time. In the years since the crisis, land line calling has become even more fruitless and mobile number calling requires prior consent due to the Telephone Consumer Protection Act (TCPA). Collections managers who do not have well-managed dialing practices are taking disproportionate financial, regulatory and reputational risks.

FIs with a more sophisticated approach to communication fared better than their peers during the crisis and are better positioned to deal with the constraints on customer dialing imposed by the impending Consumer Financial Protection Bureau (CFPB) call-cap rules[2], state level anti-phone harassment laws, and increased media attention on "robo-dialing." Multi-channel strategies spanning phone, SMS and email, underpinned by predictive analytics and integrated data acquisition, are commonly seen at these financial institutions.

While phone will continue to be an important channel in the next recession, it needs to be deployed with a more segmented and optimized view of how it can be most effective.

[2] In May 2019 CFPB issued a Notice of Proposed Rulemaking to set limits on the number of calls 3rd party debt collectors may place to reach consumers at no more than 7 attempts by telephone per week

6./ Offers were less effective. Before the crisis, creditors placed great faith in offers to help consumers resolve delinquency. These generally incorporated minimal concessions in fees, payments or interest charges, or took the form of limited offers to settle debt that was well past default. However, these offer suites were not generally geared to the more financially sophisticated customers that entered delinquency during the crisis and as a result were not successful. Moreover, forward-looking projections of settlement and payment plan performance, if it existed at all, was not based on a recessionary environment.

Since the crisis, for-profit debt settlement companies (DSCs) have emerged, and these firms offer value propositions that, for many consumers, are more compelling than what traditional creditors have at their disposal. For example, DSCs offer a consumer advocate that might resolve all debts at a steep discount to what debtors might achieve if they worked directly with creditors. In the last ten years the DSC industry has consolidated so that there are now only several large players left, but these have developed a sophisticated understanding of how to best serve debtors struggling with repayment to several different creditors. As a result, the importance and effectiveness of DSCs are likely to be greater in the next contraction.

Facing competition from DSCs, FIs need to create offers which emulate the features DSCs have stressed, such as debtor advocacy, a powerful value proposition, and speedy resolution. Offers should be straightforward and easy to understand. Furthermore, creditors should develop both a proactive and reactive strategy on how best to collaborate with DSCs and the customers who are working with them.

B. *Preparing Today for an Uncertain Tomorrow*

If creditors aim to be as successful as possible in the next economic downturn, they need to invest now in their collections and recoveries capabilities. More specifically, they need to develop the following capabilities:

1./Develop detailed downturn monitoring reports from internal and external data sources. We recommend the compilation of detailed reports to monitor recessionary indicators. Banks and card issuers possess valuable proprietary data about customers, such as saving and spending patterns, and these offer a more immediate guide to prevailing economic conditions than, for example, last quarter's GDP growth data. Collections departments and risk leaders should examine this data closely and ask questions like: are customers spending more or less on luxury goods? Is the ratio of outstanding credit card balances to checking account balances suddenly shifting in certain geographies? The answers to these questions can be incorporated into detailed recessionary reports.

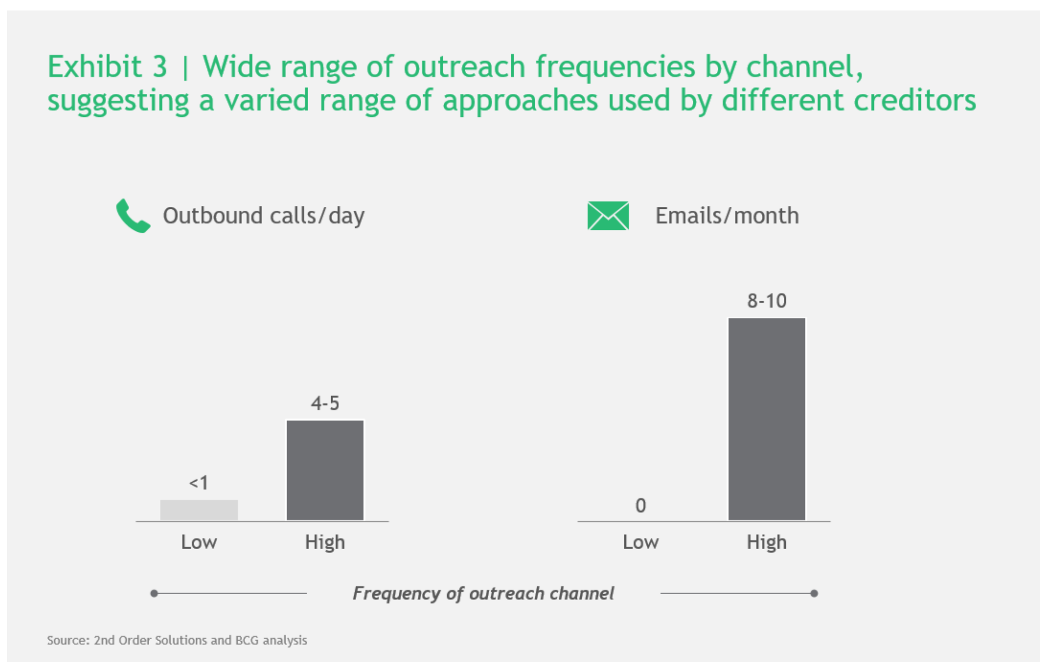
2./ Agree and apply key performance indicators (KPIs) on common thresholds. There should be agreed and consistent definitions of what constitutes a recessionary climate. It is not helpful, for example, for a bank's auto finance unit to define a "severe recession" according to different criteria than the credit card business. We suggest the creation of multiple recession modeling scenarios, with varying severities and durations, developed cooperatively by different divisions within the bank but which are ultimately the responsibility of the chief risk officer (CRO). These scenarios should underpin assumptions used to create staffing plans, expense projections, and facilities assessments. They also create a common language to be used when a slump begins. It becomes the responsibility of the CRO and chief executive officer (CEO) to announce unambiguously that a downturn is occurring, which again prevents different parts of the bank making different assessments and taking uncoordinated actions.

Moreover, having an agreed plan of action for reacting to a downturn is critical. Best in class organizations employ defined strategies that are triggered when key thresholds are met. For example, if the likelihood of an imminent recession increases from 50 to 75%, then an increase in hiring for front-line collector positions is immediately triggered.

3./ Invest immediately in shifting towards a digital-first collections model

Relative to the last recession, leading FIs have invested significantly in digital collection channels, where a greater portion of their outreach and fulfillment is done without a phone call. Capabilities such as e-mail and SMS outreach and the ability to fulfill most collections requests on-line are becoming table stakes yet we see a varied approach in frequency of outreach by channels (see Exhibit 3). In the US context, we do not feel that these digital channels have replaced the phone, but need to be strong complementary channels for both contacting customers and fulfilling their needs.

In our subsequent publications, we will dive deeper into digital collections practices, which at scale, are usually more effective and more efficient, with a superior customer experience.



4./ Enable a strong governance structure. At most banks, organizational responsibility for collections sits at the awkward junction of credit risk, operations, and product management. These three functions tend to have different priorities, and their respective chains of command usually don't meet until they reach the bank's CEO.

Many banks organize collections into a co-management model in which responsibility is split between credit risk and operations. We believe that a model wherein there is a single executive accountable for all aspects of collection strategy, analysis, and operations is preferable (see sidebar governance in collections). During last recession, leading FIs were willing to spend an extra dollar to reduce credit losses by one dollar because lower loss rates were prized so highly by investors and regulators. However, this sort of marginal benefit versus marginal cost outlook is more difficult when it requires coordinated decisions by multiple C-suite executives, each with different functional goals. Even worse, a collections department that is run like a cost center will habitually optimize for operating expenses rather than NPV or net credit loss, with deleterious results. For example, one top-ten card issuer scaled back litigation to reduce expenses and subsequently saw an outsized increase in losses that led to a $50M+ net negative impact.

GOVERNANCE IN COLLECTIONS

We think it is best for collections to be led by a single, accountable executive, even if this means that one executive is answerable to multiple stakeholders. One of the benefits of this model is that sorting out organizational confusion is the responsibility of only one person.

However, if managerial responsibility for collections has to be shared between credit and operations, there are several steps which can be taken to curtail dysfunction and poor performance. Such firms should establish:

- **Cross-function steering team** – to enable rapid response through agile decision making e.g. a weekly stand-in meeting with agreed guardrails for decision making
- **Unified goals** – credit and operations must have a single set of agreed goals, priorities and key performance indicators (KPIs)
- **Unified management reporting** – it is a grave mistake to create multiple sets of collections reports (e.g. one set for credit leadership and another for operational leadership. There should be a single set of simple reports, with agreed goals and metrics, disseminated across the entire organization
- **Collaboration** – ensure collections analysts, modelers, operations staff and IT personnel co-locate regardless of organizational affiliation, and use common messaging and collaboration tools to create a sense of being "one team."

5./Know how and where to increase staffing. The capacity to adjust and increase staffing quickly without undermining agent quality is, perhaps, the biggest single difficulty collections department face in the heat of a recession. In the financial crisis, when delinquency volumes were increasing rapidly, creditors discovered that internal hiring channels were inadequate yet outsourced agencies were of little help as they struggled to meet the needs of all of their clients. And for both insourced and outsourced agents, FI's suffered from so many inexperienced collectors bringing down overall effectiveness. Consequently, the collections department needs to have very specific, granular, and stress-tested plans to increase staffing in a downturn. These plans should assume that if early stage delinquencies increase by a certain percentage, late stage delinquencies and defaults will most likely increase even more.

This is *not* just a problem for the Collections department. It will also have significant impacts on HR (expedited hiring / recruiting); facilities (e.g., to open new locations or provision more computers); and procurement (e.g., to quickly onboard new third-party agencies). To ensure demands are met, each of these functions will need detailed plans and established patterns of decision-making and collaboration.

Contingency planning for recession at an FI should not only include increasing staffing within the collections department but should also include the possibility of borrowing personnel from other departments. Staff in functions like customer service and tele-sales could be re-trained and rapidly deployed in collections. In fact, leading organizations have already cross-trained service staff in collections to prepare for a potential downturn.

It is important to include third party agencies in this planning process as well. As we have seen, smaller clients tend to be pushed to one side in the effort to serve bigger or more proactive and watchful clients, so FIs need to know how their chosen agencies will respond in a recession and if they can be sure they will receive adequate attention.

Uncertainty and lack of clear plans in light of a quickly changing situation is a difficulty many collections departments will almost inevitably face in the next economic downturn. However, those FIs that take the steps outlined above will be quicker and more effective in their response to a downturn. There should be no delay in taking action today to prepare for that eventuality.

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