Strategy management systems for collections

White paper
Introduction to strategy management

A strategy management solution for debt collections offers the potential for significantly improving operational and delinquency performance for organizations of various sizes and types. Many of these solutions, sometimes referred to as adaptive control systems, are geared toward supporting a variety of decision-making activities such as cross-sell, repricing, credit line management, authorizations and deferments. However, the focus of this white paper will be debt collections.

Large financial institutions have been under significant consolidation pressure during the past decade. These institutions are challenged with efforts to combine multiple legacy systems, develop common user interfaces and analyze performance metrics across the organization. During the same time, new adaptable technology allowed institutions to replace or supplement existing systems. Interestingly, smaller organizations also have benefited from new decision technology in terms of affordability and availability.

Not only are financial institutions burdened with consumer debt, but health care provider groups, hospitals, utility companies and the telecommunications industry are experiencing the same challenges of improving operational efficiencies and bad debt collections. The purpose of this white paper is twofold: to explore the key components of a comprehensive strategy management solution for collections and to assess the features of customized software and application service provider (ASP) offerings available in the marketplace. Case studies are presented to demonstrate the value of these solutions.

Understanding the key components

The components of a strategy management solution for collection activities include decision technology, predictive scoring, analytical reporting, and business consulting and support. The combination provides for comprehensive and powerful solutions that do not necessarily equate to overwhelming complexity.

Decision technology
The decision engine is the core machine driving customer information into actionable recommendations. Since the primary aspect of a collection solution is to maximize collection results and minimize costs, decision-making should be based on the evaluation of current strategies, historical performance and business policies.

Predictive scoring
The purpose of predictive scoring is to eliminate the need for judgmental assessment when considering consumer behavior. The scoring engine component takes raw data and transforms it into a simple, actionable score. Examples of scores that predict a variety of outcomes include early delinquency, late-stage delinquency, charge-offs, bankruptcy, debt recovery and revenue. Scores can be derived using credit reporting agency data, internal attributes or a combination of both. Once a score is calculated, a specific outcome can be rank ordered in an effort to prioritize activities such as early collections.
Analytical reporting

The purpose of analytical reporting is to provide interactive, quantitative feedback about customer management strategies, scorecard effectiveness and emerging portfolio trends. Scorecard monitoring, performance and strategy monitoring are just a few types of reports to consider when observing the strategy management environment.

Score distribution comparison, scorecard performance and characteristic evaluation are reports beneficial to evaluating a scorecard. A score distribution report is used to see if the actual score distribution has changed from the forecasted distribution. If a shift occurs, this may indicate that the model is not operating at peak performance. A scorecard performance report verifies that the model still ranks the outcome predicted. Evaluating characteristics focuses on identifying which characteristics are more powerful than others in explaining scorecard and policy rule performance.

Two primary strategy development reports include score distribution and dual score matrix distribution. These reports are used to determine thresholds for account segmentation. Accounts are segmented into distinct groups and then assigned specific actions. Reports generated for monitoring collection workloads and resource availability are essential to supplement the strategy development process.

Strategy monitoring includes evaluating delinquency ratios, account-level delinquency movement, cure rates, delinquency movement, payment projection and recovery rates. In general, these reports are used to determine the effectiveness of a collection strategy in production. For example, delinquency movement reports are used to monitor the movement of accounts from one level of delinquency to another. If a lower percentage of accounts are rolling to the next delinquency level over time, then the collection strategies are effective. These reports are critical to the success of Champion/Challenger testing. Strategy monitoring reports can be analyzed in a variety of ways, such as portfolio type, product type, risk grade, behavior score and region. This will ensure that test criteria are isolated to properly compare Champion/Challenger test strategies.

Business consulting

The last component of a strategy management solution for collections is business consulting. Business consulting can range from developing scorecards and strategies to quantifying trends, assessing strategy tests and creating recommendations. For example, a quarterly strategy review should focus on recent scorecard performance, a comparison of strategy test results and collection resource usage. When the strategy review is complete, strategy recommendations would be considered.

Business consulting also can involve integrating strategy management with operational programs such as automated collection systems, autodialers and operational workflow re-engineering initiatives. A best-practices approach to consulting should provide both industry-specific knowledge and business intelligences along with technical expertise to execute solutions that are customer-focused. Ultimately, best practices in business consulting are meant to be an extension of a client’s credit risk management department.
Strategy environment

A strategy environment successfully allows strategic and operational objectives to interrelate and to provide a foundation for continuous progression. As part of the strategy environment, strategies are designed, placed into production and monitored for results.

One method for implementing a strategy is the use of decision trees. In general, the use of decision trees maximizes the decision-making process. Decision trees are developed to segment accounts or customers into similar populations, allowing a systematic approach to choosing between several recommended actions. Although simplistic, a best-practices approach to design and implementation should be adhered to, ensuring compatibility with strategic business objectives.

Portfolio segmentation

Because every account and consumer behaves differently, portfolio segmentation is the foundation for developing precise and effective collection management strategies. The purpose of portfolio segmentation is to systematically divide a set of accounts or consumers into minisegments for more appropriate treatment. A variety of factors can be used for portfolio segmentation, including:

- Product types, such as secured versus nonsecured
- Risk levels, such as high loan-to-value ratio
- Policy exceptions, such as handling of employee accounts
- Contractual obligations, such as guarantor accounts
- Behavior, such as lazy payers
- Demographic factors, such as regional location

Risk evaluation

One way to maximize the use of predictive technologies, such as a risk score, is to use a cross-matrix with another attribute of substantial value, such as contingent liability or balance. By taking two attributes and creating a cross-matrix including metrics such as loss rate, delinquency and recovery rate, you begin the process of a swap set analysis. With additional information, account segment selection can be refined, thereby swapping in and out account segments based on a set of criteria. This refinement of evaluating risk produces a more precise assessment of the risk level for the portfolio.
Exception processing
Exception processing is a set of predetermined rules that organize and direct the handling of accounts to appropriate resources — for example, a bankruptcy specialist. Exceptional conditions exist when accounts are excluded from standard processing across the enterprise and require special strategies such as:

• First, second or third payment defaults
• Recent and recurring collection accounts
• Employees, VIPs and businesses
• Legal status
• Nonsufficient funds

Strategy design and development
There are many considerations when designing and developing collection strategies. First, it is important to have an understanding of current policies, procedures and business goals. Second, identify an area for improvement, such as delay account treatment or accelerating accounts using a dual score matrix. Third, review score distribution reports to determine appropriate cutoffs and review account distribution reports to determine operational impact such as collection workloads.

In addition to selecting the score thresholds, other selection criteria such as number of days delinquent and balance are used to refine segmentation. Once the segments are established, actions are defined and recommended for each population. Before implementing a new strategy, it is imperative to document the entire process, including:

• Goals or purpose of the strategy
• Expectation of the results
• Evaluation timeline
• Acceptance criteria for success or failure

Champion/Challenger strategy testing
Since the world of lending and credit extension is constantly evolving, collection strategy testing becomes increasingly important. Champion/Challenger strategy testing is performed using a sample segment. The results provide a learning tool for determining which strategies are most effective. This allows strategies to be tested before rolling them out across the entire portfolio. This experimental activity allows an organization to observe the effectiveness of new strategies, support continuous improvement of collection approaches and adapt to changes in consumer behavior.
The methodology behind testing is simple. First, the current environment should be assessed to identify specific areas for improvement. Then, a test plan is designed. A well-crafted test plan is the blueprint for success — it should include well-defined objectives and goals, a proposed strategy design, a specific sample size, operational considerations, execution plan, success criteria and an evaluation timetable. After the framework for the test plan has been outlined, running “what if” scenarios will refine the strategy.

In the next phase, implementation occurs following the directives of the test plan. Evaluating strategies commences after implementation and continues throughout the duration of the test. This includes analyzing metrics established during the test plan phase to identify trends and changes as a result of the new challenger strategy. The challenger strategy is declared the new champion if the test meets or exceeds expectations.

However, before proceeding with the new champion strategy over the entire portfolio, consider any operational constraints that might hinder its success on a grand scale. Once these operational constraints have been identified and their impact assessed, the new champion strategy is ready to be implemented.

An after-test assessment provides a continuation of the learning process, for which feedback should be incorporated into the next generation of strategy tests.

Strategy evaluation
Type of debt and business policies will influence the approach when designing, developing and evaluating strategies. For example, a large, medical provider collecting medical debt would take a slightly different approach than a subprime automobile lender. Medical debt is unsecured, while automobile installment loans are secured by collateral. Another difference between these types of debt is that medical debt collections deal with insurance claim resolution and copayments, while automobile lenders focus on the value of the automobile. In both cases, access to performance data for monitoring activities is critical.

If a new collection strategy for medical debt collections has been introduced, collectors may need a week or two to adjust to new workload volumes. Proper planning, such as evaluating distribution reports beforehand, will allow workload balancing immediately. Over the next few months, performance monitoring takes place. This includes evaluating the effectiveness of negotiated payment plans, analysis of delinquency movement and operational cost savings. After several months, monitoring late-stage delinquency, agency placement and write-offs becomes a priority.
Comparison of the solutions available

There are two primary solutions available today — ASP and a fully customized solution. ASPs host a generic application, which places them in a unique position to collect and manage data, perform analytics and provide consulting regularly. Additionally, some ASPs can host a more customized solution that begins with a template, modification of the source code and specific business requirements providing a more personalized solution. With a fully customized solution, there is a significant amount of capital and resource investment required to implement. Although some custom solutions offer hosting services, the advantage offered by the hosted ASP can significantly reduce the amount of capital outlay for the entire solution.

The target client for these solutions depends on factors such as volume processing, quality of portfolio, business requirements and financial investment decisions. Given advances in technology, many of these solutions are available to small and medium-sized organizations and considered adaptable to accommodate a growing business. In the table below, features of the ASP and fully customized solution are explored:

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<tr>
<th>Comparison</th>
<th>Application Service Provider (ASP)</th>
<th>Custom solution</th>
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<tbody>
<tr>
<td>Customization</td>
<td>Most ASP environments do not allow for customization; however, they could potentially provide a significant portion of the functionality above and beyond a client’s necessary requirements. May require modifications of internal processes to accommodate a less flexible solution.</td>
<td>Most custom solutions call for very specific business requirements. Can be augmented with operational re-engineering initiatives.</td>
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<tr>
<td>Investments of resources and capital</td>
<td>Requires little, if any, technical support and training. Limited IT/data resources. Very low to low start-up capital requirements. Return on Investment (ROI) is typically less than one year and more often just a few months.</td>
<td>Requires labor-intensive support and training. Significant IT/data resources. Medium to high start-up capital requirements. ROI is more complicated to determine and investment is over a longer period.</td>
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<tr>
<td>Implementation time frame</td>
<td>Generally, strategy management systems in an ASP environment require a few weeks to implement, with additional time required to implement initial business strategies.</td>
<td>Typically one or more years, depending on the amount of personalization. Customized solutions are a challenging undertaking. Using a quick start or template solution could reduce the amount of time to production.</td>
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Case in point

The question of how to best manage collections confronts every lender, large or small. Not all collections accounts are alike, yet customers with very different risk levels and payment histories are lumped together in the same collections queues, receiving the same treatment. Strategy management systems address this issue by assisting lenders in segmenting these accounts and ultimately identifying varying risk levels so appropriate actions can be assigned. This approach results in significant efficiency gains and more effective strategies.

Case study: captive finance success story
Potential benefits of collections strategies are better understood by examining the experience of one of the top 10 captive finance organizations in the United States. This lender wanted to segment its collections population in various risk grades so varying collection treatments could be applied to different segments.

The lender implemented a service bureau strategy management system that rank ordered all accounts that were one day or more past due and potentially heading to the collections queues. Rather than make manual calls to the low-risk population at 12 to 15 days past due, the lender decided to take no action in the first 30 days on the top-scoring 30 percent to 40 percent of the population. Bypassing these accounts provided better customer service to the most reliable customers and reduced overall operations costs in the early-stage units by 20 percent. The lender was able to focus stronger and more immediate effort on the higher-risk accounts. With a portfolio of nearly 2 million accounts, the lender realized considerable savings. This test represents the first phase of the lender’s automated installment lending decisioning.

During the second generation of strategy testing, the lender experienced an efficiency return of 40 percent, again without a significant impact to delinquency rates. Analysis of this data suggests the anticipated savings easily could be improved by another 20 percent in the third generation of testing without a measurable increase in overall delinquency rates.

Case study: leading regional bank success story
Another example of benefits reaped from collections strategy management systems is the experience of a leading regional bank. Before implementation, this bank outsourced calls for all collection accounts reaching 10 to 12 days past due. Their strategy management system allowed the bank to organize its portfolio into three distinct risk grades: low, medium and high. The bank then tested a strategy where half of the higher-risk accounts were kept in-house.

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<td>User interface</td>
<td>Business consultants implement strategies and make system changes</td>
<td>Customized screens for client interaction</td>
</tr>
<tr>
<td>Reporting</td>
<td>Client reports are created and delivered periodically</td>
<td>Customized reporting and data warehouse, with resources required to create a reporting suite</td>
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When results were compared three months later, the data indicated that the bank’s internal collections efforts were twice as effective as the outsourcing option. Additionally, low-risk accounts were not outsourced or handled at all in the first 25 days of the delinquency, without a notable increase in delinquency rates or charge-offs. The bank discovered more than 55 percent of the collections population contained low-risk accounts that self-cured, resulting in substantial bottom-line benefits.

During the second generation of testing, the lender experienced substantial cost savings. First, the lender was able to bring outsourced debt accounts back in-house for collection activity without an increase in collection resources. This resulted in the elimination of agency costs. Second, two collection call centers were combined into one, significantly reducing overhead expenses. With this reduction in resources, the lender experienced little impact to delinquency levels. The combination of both activities was accomplished by direct use of the strategy management solution to automate the risk-evaluation and decision-making process.

**Conclusion**

Collections strategy management systems are extremely effective in lowering collections costs, increasing operational efficiencies, reducing delinquencies and improving customer service. Both ASPs and custom software solutions provide the necessary components to a comprehensive strategy management solution for the collections industry. In general, these solutions are offered to small, medium and large institutions across multiple industries to enhance the decision-making process. In the past, lenders viewed decisioning systems as being complicated and cost prohibitive. In today’s marketplace they are available to all organizations and have provided enough value to be deemed indispensable.