



# Another Approach to Managing High Risk Customers

Vision and Strategy Document



## Business Overview

With the sustained economic downturn of the past few years, lenders are seeing an increase in delinquent dollars coupled with a general decrease in overall collection rates. This trend makes it increasingly critical that companies take a more proactive approach to managing their high risk current and early stage delinquent customers that are “At Risk” for a prolonged period of non-payment, which for the purposes of this document is defined as falling behind by two or more payments.

Using improved modeling and customer management strategies to target “At Risk” customers, progressive financial service companies can reduce credit losses by decreasing their portfolio’s overall “At Risk” exposure levels and by helping customers before it is too late. By proactively establishing contact with these customers before they reach their highest stress point, companies can work with them to identify potential internal and external options that will help them through an often confusing and difficult time. This approach will help companies reduce delinquency in the early stages, and that is critical because customers who historically roll to more than two payments delinquent, are 50% more likely to charge off than those customers who do not. More importantly, they can prevent full utilization of the customer’s credit line by proactively reviewing “At Risk” current customers at pre-defined utilization levels, thereby reducing the overall delinquent dollars entering collections.

Progressive financial service companies will remove the limitations of traditional collections processes that require a customer to reach a certain level of delinquency before actions can be taken and will instead focus on a customer’s current financial condition to determine the most appropriate course of action needed to reduce future losses.

## Identifying “At Risk” Customers

Effective “At Risk” Customer Management requires the combination of traditional risk analytics and customer contact referrals with the addition of transaction risk analytics to help quickly identify changes in behavior that may indicate a change in a customer’s risk profile. To produce optimal program results, automated decision capabilities will need to be combined with manual reviews from skilled lenders to make difficult credit/exposure decisions on the more “grey” populations.

Ultimately, “At Risk” Customer Identification Strategies need to reduce the high risk exposure levels within your portfolio by identifying customers who have a high likelihood of going past due before they fully utilize their available credit lines. One of the best places to start is by simply targeting sub-populations of open accounts with excessively high charge-off rates that still have credit line availability. No matter which strategies are used, the challenge of trying to identify which customers are truly “At Risk” still remains because many of these higher risk accounts may also be your most profitable customers. As a result, very precise targeting strategies are required to ensure that the right customers are being selected.

### **Developing “At Risk” Customer Identification Strategies**

Before considering how your “At Risk” Customer Identification Strategies will be developed, one must determine what data will be available, how frequently it will be available and how it will be accessed. There are three primary sources of data available in most organizations: Internal Risk Data, Internal Referrals, and External Risk Data. Internal sources of risk data come primarily from the Master File, Authorization Logs, Collections Operations, and, in some cases, Prospect Databases. External data sources, principally from credit bureaus and scoring institutions, are added to internal data to identify trends, review credit policy, and help to set overall account management strategies.

Methods of strategy development are dependent on the type, quantity, availability of information, tools, and the skill sets of people developing the strategies. Early industry techniques used account management strategies that were based on judgmental consensus. Managers would leverage intuition aided by some simple analytics to develop strategies, and then validated them by generating reports to estimate the potential workload. The success of these early strategies were based primarily on the experience levels of the managers, and partly on the added learned value of champion / challenger strategy testing.

As greater access to data and experience was gained, many organizations began to use univariate and bivariate analysis to help identify “At Risk” accounts. These methods were efficient, simple to execute and easily explained. The problem with them though was twofold, they can only consider a couple of characteristics at a time, and “At Risk” accounts are usually more difficult to identify. Today, these techniques are primarily used as exploratory steps to determine what characteristics would be chosen when developing strategies that use a combination of multivariate analysis for model development and decision trees for strategy development.

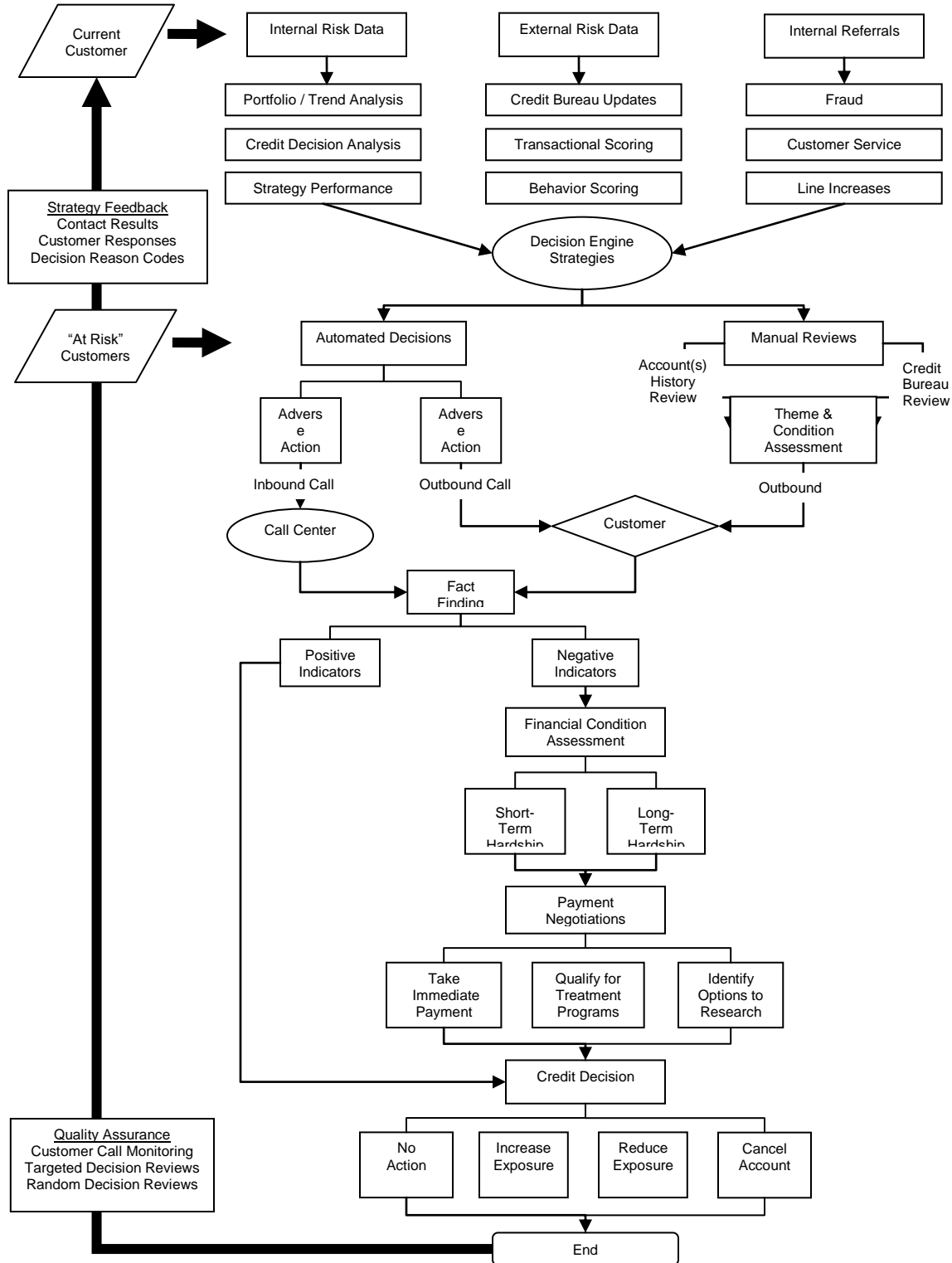
### **Managing “At Risk” Customer Strategies**

Account management systems such as Fair, Isaac’s TRIAD and TRIAD Transaction Scores (recently added from the HNC acquisition), and AMS’ Strata are some of the industry tools available to provide a foundation for managing “At Risk” Customer Identification Strategies. “At Risk” strategies can apply actions to accounts based on strategy criteria. Those actions can include: reducing credit lines, canceling accounts, routing them for a manual credit review or routing them to a collections group trained to work with “At Risk” current customers. Once experience has been gained at the account level, the next level is to move to overall customer relationship exposure management.

Regardless of the strategy development method or account management system used for execution, strategies need to be tested and monitored carefully. New strategies should be introduced as challengers in a controlled manner, to minimize any potentially negative customer impact. Performance measures and tracking reports should be agreed upon before implementation, and developed prior to the implementation of a test program. Depending on the type of strategy and how it is implemented, the results should be monitored and tracked on a daily, weekly, and monthly basis until a general comfort level is achieved. In addition, it is imperative that the strategies are challenged frequently because credit behavior trends change over time, and because it is critical to ensure that automated actions only occur on accounts that are “At Risk” of having a prolonged period of non-payment.

## Emerging Strategies and Processes

The following process flow outlines the key steps for executing an “At Risk” Program.



### **Step 1: Pre-Processing**

The pre-processing stage essentially prepares the data input file for the account management system. In preparation, data from other sources such as collections, authorizations, and real-time transaction risk scores, are appended to the Master File for use in segmentation, scoring, and strategy action assignments. Examples of other data sources include: credit report data, profitability calculations, or data that resides in systems outside of the account management system. If used, these sources of data will have to be available for batch processing. It is not advisable to rely on a manual process to make the data available for batch runs, because if the data is not available, the batch could fail or run off of old data. This would invalidate scoring models and strategies, and possibly result in the wrong actions being assigned to accounts.

### **Step 2: Account Identification Strategies**

Once the file has been prepared, it will then be evaluated by the account management system decision engine to score, segment, and determine which “At Risk” customers should receive an automated decision action, and which should be sent for a manual credit review. By sending an adverse action letter, automated decision actions, which include reducing credit lines and canceling accounts, are normally taken on only the highest risk segments. It will be important to be as specific as possible, using non-jargon terms, when explaining why the action was taken and how a customer can get their account back in good standing, to consequently reduce the amount of inbound calls. If a customer is selected for a manual review, they should be sent to an experienced Lender who will then determine the appropriate action to be taken. The right balance of automated decisions and manual reviews is traditionally dictated by the number of available skilled resources and the value they are adding to the process. As a program gains more experience, this ratio of manual reviews to automated decisions will shift more to the automated side. This shift will allow Lenders to take on the more strategic role of testing new strategies and working with the population of “At Risk” customers generated from inbound contacts.

### **Step 3: Operational Execution**

Once the manual judgmental credit review begins, a Lender will determine, by reviewing the customer’s current credit file and their internal account history, if the concern identified by the targeting strategies makes sense. If the Lender feels the concern is valid, he/she will make their final credit decision and send an adverse action letter explaining the reason for the action. If they need more information to make their final credit decision, they will contact the customer directly. During fact finding discussions, Lenders should look for positive or negative indicators to make an assessment of the customer’s current financial condition. This includes determining if they have both the willingness and ability to sustain timely future payments. If the customer indicates a financial strain, it will be important to understand if they are suffering a short-term hardship (1-3 months) or a long-term hardship (>3 months) to determine the appropriate payment negotiation starting point. Many organizations also use advanced econometric modeling techniques to determine the most appropriate treatments to offer. But, in lieu of these tools, experienced Lenders with a background in collections can admirably handle this payment / treatment negotiation process. The results of these payment / treatment negotiations should dictate the severity of the final credit decision. Special consideration should be given to customers that are cooperative and agree to make an immediate payment or enroll in a treatment program.

#### **Step 4: Program Measurement and Strategy Refinement**

Once the “At Risk” Customer Management Program is underway, the results need to be evaluated and measured on two dimensions. From an automated decision standpoint, strategy results will be measured via traditional portfolio performance reporting and analysis measures that leverage the powerful strategy feedback provided by Lenders as a result of customer conversations. From a manual judgmental review standpoint, Lender’s decisions will need to be actively measured for consistency to determine the value of their efforts. This can be evaluated by measuring the performance / value of the “bad” balances saved from going delinquent, and the “good” balances maintained and/or grown at an individual Lender level. In addition to measuring credit decision performance, Lenders need to be measured against traditional collections metrics to understand how effective they are at getting “At Risk” customers to keep their promises. These two dimensions are then pooled together to understand the overall value that the “At Risk” Customer Management Program is providing to the organization.

## Considerations

#### **Customer Perception**

The most important thing to remember when executing an “At Risk” Customer Management Program is managing customer perception. While customers may have a difficult time understanding why you are taking actions on their current account, a properly executed program can actually turn effected customers into your biggest fans. Earning a reputation as a company willing to help their customers during both the good and bad times will long be remembered over any initial negative resistance, once they have rebounded from this financial setback.

#### **Legal**

From a legal standpoint, companies will need to comply with both the traditional lending and collections regulations; the Fair Debt Collection Practices Act (FDCPA), Regulation B: ECOA, and Fair Credit Reporting Act (FCRA). The standard adverse action notifications will be required for any negative actions taken on customer’s accounts, and it will also be important to safeguard against dunning current customers. Dunning is the practice of directly asking a current customer for payment before their due date. With proper program execution, Lenders should focus their conversations on the customer’s credit issues so that they can easily transition into a conversation regarding how they plan to maintain timely payments if an issue is identified. As with all new customer management initiatives, it will be important to get your Compliance and Legal departments involved early on to ensure their buy-in.

## Conclusion and Recommendations

The collections environment continues to be challenging, but by being proactive and removing the boundaries of traditional collections treatment practices, progressive financial service companies will be able to win their rightful place in a customer's payment hierarchy during difficult times. Companies that offer ways to help their customers through difficult times will not only survive, but will most likely gain loyal customers, while those that continue to follow the traditional collections methods and tactics, will continue to struggle.

The following items are recommendations to organizations that are developing or planning to develop an "At Risk" Customer Management Program.

1. When developing your program, use a phased approach that allows for pilot testing. This will reduce risk and provide ample time for working out the kinks before it goes live to your entire customer base.
2. Employ a Champion/Challenger methodology to develop and manage your "At Risk" Customer Identification Strategies, and never stop testing new theories or opportunities.
3. Capture as much data as possible from Lender conversations for evaluation and use in the strategy enhancement and refinement process.
4. Hiring the right people and providing the right training is a critical success factor for "At Risk" Customer Management Programs. Lenders should possess both collections and credit backgrounds, and should be compensated at a senior level.
5. Develop a meaningful incentive plan that rewards Lenders for doing the right thing for the company as well as the customer.
6. Build safeguards into your credit decision process to ensure that consistent lending decisions are being made and that quality customer interactions are taking place. Completing a specified level of random reviews of credit decisions and customer calls for each Lender will help ensure that the program's business objectives are achieved.

## About Bridgeforce

Bridgeforce specializes in serving the needs of companies that either directly manage account receivables and financial transactions, or that aim to provide software and technology products for these market segments. Our services span across multiple industries, including: consumer lending, small business lending, auto lending, retail banking and brokerage, healthcare, insurance, telecommunications, utilities, and call centers.



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