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Risk Practice

Going digital in collections to improve resilience against credit losses

With delinquencies on the rise, lenders need to transform their contact approaches now to suit customer preferences.

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Since the financial crisis, losses at many lending institutions have been historically low. The period of economic recovery after 2008 to 2009 was defined by accommodative monetary policies, strong demand from a burgeoning Chinese economy, and a massive increase in cross-border trade. The financial markets took off. Credit growth returned—faster in North America, more moderately in Europe. In the low interest-rate environment, lenders adjusted their lending policies to acquire more customers again.

Perhaps not surprisingly, institutions allowed their collections capabilities and recovery operations (at least for unsecured loans) to languish during the long up cycle. But now household debt is at an all-time high, delinquencies have been rising, and forward-looking macroeconomic indicators are softening. As a result, lenders are reexamining their capacities for handling delinquencies. Part of that reevaluation for heads of collections involves taking into account changes in the consumer landscape. For example, consumers increasingly communicate with financial-services providers through text messaging and prefer self-service digital channels. They do not respond to repetitive collections phone calls—an approach further complicated by stricter regulations against harassment.

As the evidence for a deteriorating credit cycle mounts along with increasing losses, lenders can take steps to increase institutional resilience. By strengthening collections capabilities and embracing digital communications, they will be better prepared to address any further increase in delinquencies that may occur.

The canary in the coal mine?

Do rising credit delinquencies foreshadow economic down cycles? Are collections departments the "canary in the coal mine" of an economy, indicating by upticks in demand an approaching slowdown? Household delinquencies in the United States hovered at historically low levels through 2016. They began to climb in 2017, however, rising steadily across home-equity and auto loans, as well as credit cards. By the fourth quarter of 2018, delinquencies had reached their highest point in seven years. Over the last 18 months, both delinquent balances and losses have risen for nearly every unsecured lending product in North America. Credit cards in 90-plus days' delinquency, for example, have risen by 5.3 percent, while auto loans in this category have ballooned by 14 percent.[1] Whether recent trends signal a return to "normal" or the onset of a cyclical downturn remains to be seen.

Should signs of a slowing economy continue to gather, institutions will want to recall the experience of previous downturns. Economic slowdowns involve many industries and create effects that linger beyond the point when the macroeconomy begins to recover. The implications for collections departments will be experienced not only in financial services but also in utilities, healthcare, telecommunications, and the public sector. The recently expanded client base, accelerated by new online lenders, has created vulnerabilities for institutions: some of the new customers are riskier and will likely experience financial stress early in any down cycle. The pressure to lend to these customers can even rise as the economy slows, as attracting business from an increasingly conservative consumer sector becomes more difficult.

Is 'right sizing' now wrong?

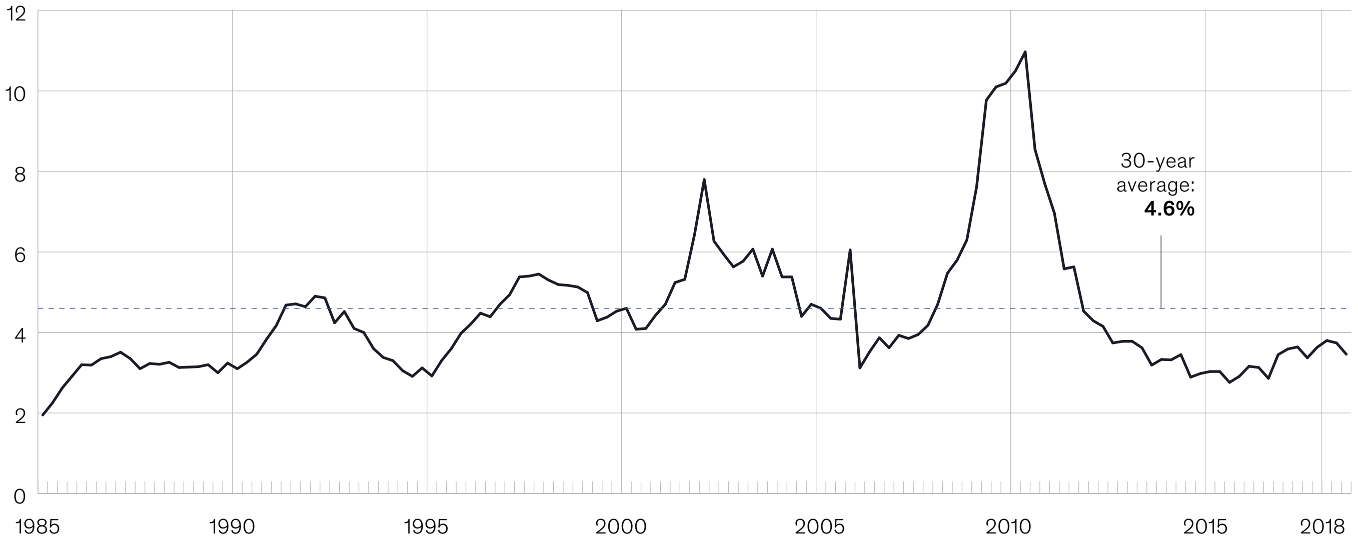
Even in an environment of average delinquency rates—for example, 4.6 percent for cards in the United States—collections operations today may be unprepared to address sudden demand. The history of credit losses is bimodal, with persistent low losses punctuated by sudden spikes; in other words, normalcy involves periods in which delinquency rates are substantially higher than average (Exhibit 1).

[1] *Quarterly report household debt and credit,* Federal Reserve Bank of New York, fourth quarter 2018, newyorkfed.org.

Exhibit 1

In the United States after the financial crisis, credit-card charge-off rates quickly fell below historical averages.

US credit-card charge-off rate, %



Source: US Federal Reserve

During the long recovery from the financial crisis, lenders closed tens of millions of accounts of risky customers, causing a flight to a new marketplace of online lenders using innovative peer-to-peer (P2P) platforms. Then, as interest revenues fell, major incumbent lenders began expanding their customer base again, while hoping that advanced analytics would enable them to avoid borrowers at the greatest risk of default. Between 2011 and 2015, for example, the average credit score of auto-loan customers in the United States fell by more than 25 points, sufficient to shift some lenders' focus from prime to near-prime.[2] Credit has not been scarce. Total household consumer debt in the United States has risen steadily for the past seven years and stands at almost $14 trillion. With strong employment and buoyant equities and real-estate prices, this debt could be maintained. Any sustained reversal of economic conditions, however, could trigger an avalanche of losses, with the most marginal customers no longer able to service their debts. And higher losses in secured borrowing could trigger a fire sale of collateral and create contagion in the markets.

This could present a serious challenge to institutions that in recent years have adjusted to loss rates that were 30 percent below historical averages. The approach they took, of cost-cutting in collections through head-count reductions and a focus on efficiency, has left little spare capacity. Now that delinquencies are growing, institutions need the capabilities to address the new demand for their services.

[2] As calculated by Fair Isaac Corporation, or FICO, a private analytics company.

Changing consumer habits: The digital generation

In addition to the likelihood that collections units are understaffed, their traditional collections methods have become less helpful. An unintended effect of ubiquitous smartphone use has been to dilute the potency of outbound calling as a way to reach customers. Despite the fact that nearly every delinquent customer has a phone, they typically do not answer calls, preferring instead to communicate (and pay) in their own time, on their own terms. They are quite adept at using smarter call-screening technology. Regulatory pressure has also blunted the usefulness of the outbound dialing tool: many card issuers have received compliance notices since 2012, making them especially sensitive to any attempt to increase contact frequency that could be perceived as customer harassment.

Despite the trend, many lenders are still focusing on the old ways of doing things. During the last recession, some firms even added staff to make more calls. Now a digital approach is needed.

How customers experience delinquency contact

A recent McKinsey survey highlighted this mismatch between the contact strategies employed by most issuers and the contact preferences of their delinquent customers. In late 2018, we asked questions of credit-card customers who recently fell into delinquency. The objectives were to understand how they experienced outreach from their card issuer, how they prefer to be contacted, and the respective outcomes of these two approaches. Based on their responses, we were able to plot the relationship between institutional contact strategies, customer preferences, and outcomes (Exhibit 2).

The three main lessons of the survey can be summarized as follows:

— Most issuers still pursue traditional contact strategies based on the delinquent customer's balance, risk profile, and days delinquent. The strong preference of lenders is to prioritize outbound phone calls and letters, especially in later delinquency. Digital contact channels, including email, text messaging, and online chat are more commonly used by institutions in early delinquency but after 30 days are largely abandoned as too passive an approach. Evidently, fewer than half of the major issuers have a true multichannel contact strategy in collections.

— Delinquent customers expressed a preference to be contacted primarily by email and text message. They also report that issuers mainly use traditional contact channels nonetheless. Lower-risk customers in particular prefer alerts and notifications via voice mail or email, and to take action in their own time. These "digital first" customers are identifiable by simple characteristics like demographic data, balance, payment behavior, channel of acquisition, and use of online banking and apps. They represent a significant portion of the total delinquent population and vastly outnumber those who say they prefer traditional channels.

— In responding to issuers' contact strategies, digital-first and traditional-channel customers behave very differently. The digital-first segment is 12 percent more likely to make a payment when contacted by the bank through a preferred digital channel in early delinquency. In late delinquency, this likelihood rises to 30 percent. The proportion of these customers who pay in full also doubles when they are contacted through digital channels. A small minority of customers still prefer phone and letter contact, a distinct population that typically pays in full.

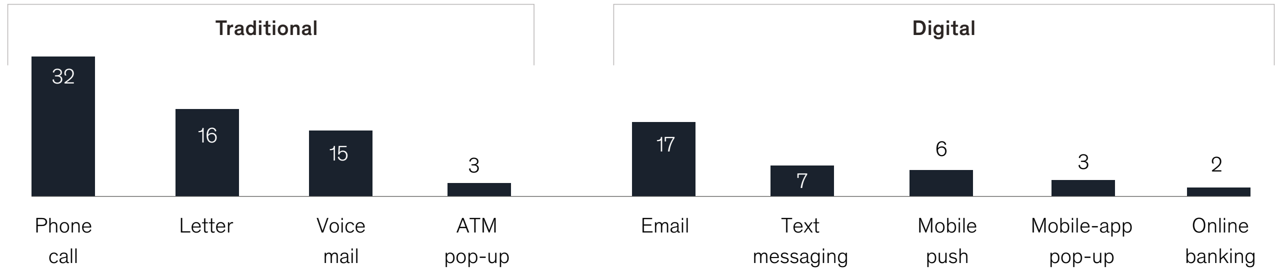
Lenders are using the least effective rather than the most effective channels

As Exhibit 2 makes clear, the channels favored by lenders for contacting delinquent customers—phone, letter, and voice mail—are now the least effective in eliciting payments. Conversely, the channels that lenders use less often—email, text messaging, and pop-up notifications—are the

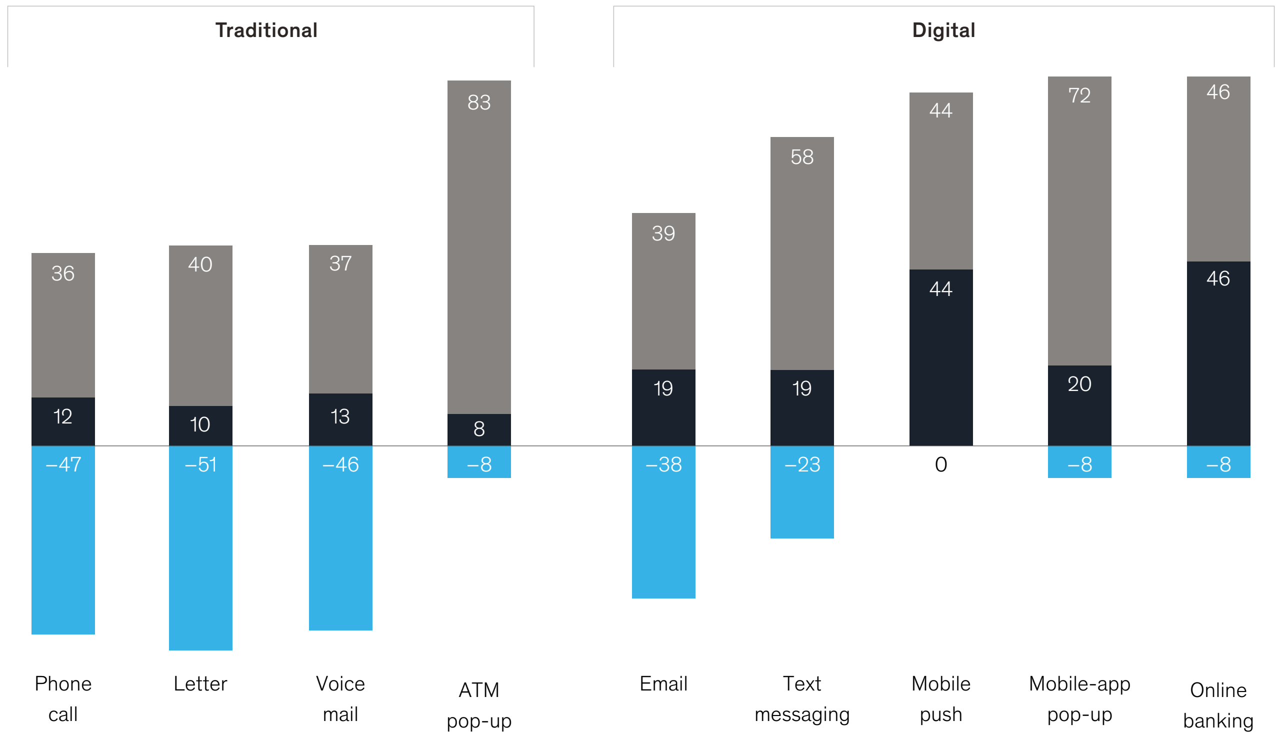
Exhibit 2

According to a recent survey, banks are not using the channels that lead to the best customer outcomes.

Method of last-contact channel for accounts 30+ days past due, % of total respondents



Payment action, by last-contact channel, for accounts 30+ days past due, % of total respondents



Note: Figures may not sum to 100%, because of rounding and omission of an inconsequential category ("Other").

Source: McKinsey survey of credit-card customers at North American financial institutions, 2018

most favored by customers today and yield the best results (Exhibit 3). Lenders, in other words, are using the least effective rather than the most effective contact channels, while customers clearly prefer digital-first contact.

Whether this mismatch is due to rapidly shifting customer preferences, a lack of digital capabilities among the issuing banks, or a resistance to change among risk-averse collections managers, the implications are the same: customers are not responding. They expect and prefer to communicate digitally, whether their financial institutions understand this or not. These expectations have already been demonstrated in other dimensions of banking operations (such as service to sales). Those banks that continue to ignore customer preferences will suffer the consequences in losses higher than those experienced by more responsive peers.

Such a competitive disadvantage could become profound in an economic slowdown. During and following the last recession, many issuers were served with enforcement actions for unfair or deceptive lending practices, including fines for harassment of delinquent customers. Of particular concern was the intimidating language used by collectors and the obnoxious frequency at which they were calling individual customers (in some cases as often as 20 times per day). As a result, many collections operations have drastically reduced their calling frequency and focused on using compliant language and noninvasive collector behaviors. Many issuers have taken away performance-related employee compensation, and punish collectors who tell customers that they must make a payment.

To avoid both harassment complaints and unwanted costs, many banks are phoning lower-risk customers less frequently—once per day or a few times per week. Lower-frequency calling is the norm for customers that have not consented to banks' calling their mobile phones through an automated dialer. Despite rising losses, furthermore, many collections units fail to raise contact rates due to internal-risk rulings. Interestingly, recent research by the US Consumer Financial Protection Bureau indicates that most issuers fall far short of their own self-imposed call-frequency caps.[3]

Banks should be able to increase contact frequency and achieve better customer outcomes if they switch to a coordinated multichannel

Exhibit 3

Customers prefer email, text messaging, and mobile channels for contact, finding traditional channels little engaging.

65%	89–92%
of issuer-initiated contact is with traditional channels (phone, voice mail, letter) despite poor response rates	payment rates can be achieved by using digital channels—online banking or mobile

Source: McKinsey survey of credit-card customers at North American financial institutions, 2018

[3] *The consumer credit card market,* US Consumer Financial Protection Bureau, December 2017, consumerfinance.gov.

approach, with smarter dialing practices and better text messaging. Newer entrants into the recovery business report higher response and recovery rates after they abandon outbound dialing completely. Their approaches focus on tailored digital messages that bypass spam filters and contain language that resonates with delinquent customers. Higher response rates have been achieved with tailored landing pages, account-specific text alerts, and email content that educates and gives hope rather than depresses customers (surprise!). Surely there are lessons here for pre-charge-off collections as well.

The collections transformation journey

In response to rising delinquencies, shifting consumer preferences, and the current regulatory environment, leading financial institutions have begun a journey of digital transformation in collections. Borrowing heavily from successful approaches used in other parts of the business, they are investing in advanced analytics, digital channels, advanced collector capabilities, and next-generation collections strategies. Recognizing that it takes time to design, build, test, and implement such strategies, these leaders have inaugurated transformation efforts with 12 months or more set aside for completion. We have observed four effective constituent actions:

1. Strengthen segmentation capabilities with advanced analytics

With rising delinquencies and resource limitations, institutions need better segmentation and fewer customers referred for personal attention. Analytics can improve segmentation efforts and enable tailored contact strategies. As institutions perfect their enterprise data warehouse and advanced-analytics capabilities, they are discovering that more can be done with what they already have in the meantime. Regulators have lately welcomed analytics applications that allow issuers to improve customer differentiation and tailor contact and collections strategies. The approach has generated better outcomes for customers. Issuers can maximize the number of customers that pay on their own initiative (self-cure) with analytics-based targeted digital campaigns for those in early delinquency or even predelinquency, while using the customers' preferred digital contact channels. Furthermore, unresponsive accounts that fit the profile for fraud can be filtered out more rigorously and sent to a separate treatment queue.

2. Develop effective omnichannel orchestration

Digital-first customers inhabit an app-based world. They expect to address their delinquency in their own time, through easy-to-use self-serve channels. The growth of online bill payment points the way for issuers. With an integrated collections platform, customers would have self-serve access to the exact same payment plans and treatment solutions as those that issuers offer over the phone. Customers should also be able, through the online self-service channel, to schedule automated future payments ("autopay").

These digital-first customers should also continue to be contacted through an orchestrated omnichannel digital contact strategy, even if they are delinquent beyond 30 days. With active-response models, business rules can be introduced such that outliers that have not responded digitally after a reasonable amount of time are passed to agents for skip-tracing and personal assistance.

3. Optimize messaging used in all customer contacts

Examples abound of delinquent customers responding positively to empathetic messages from their issuers. Instead of sending generic or passive-aggressive notices of collections, issuers can use language that highlights options for solutions and payments. Many institutions have had success with this approach. Leading issuers are also using more client-specific language in alerts, to avoid the appearance of spamming or phishing. By training and empowering collectors to have intelligent conversations using "words that work" according to customer needs—rather than standardized scripts—collections managers create a higher likelihood of finding a sustainable solution for customers.

4. Restructure the operating model to serve customer needs
The collections operating model should be structured to allocate collectors in proportion to customer needs. Institutions can better anticipate these needs by improving segmentation, as discussed previously. One step is to divert low-risk and self-cure customers away from live calling and toward digital-first solutions. For higher-risk customers, collectors can be trained to identify their needs more closely by assessing their ability and willingness to pay. These parameters help enable more effective negotiations and better outcomes. Another step is to shift staff to more personalized "ownership" teams, whose members take ownership of a customer relationship, engaging in repeated conversations with particular high-risk customers to craft personalized and sustainable solutions.

Prioritize and act now

In our experience, collections executives are never short of ideas for improvement but sometimes fail effectively to prioritize their agenda. As advocated in a book by our colleagues, *Strategy Beyond the Hockey Stick: People, Probabilities, and Big Moves to Beat the Odds* (John Wiley & Sons, 2018), a top team will create far greater impact by focusing on five to ten major initiatives than by trying to implement 50 to 100 minor ones. Operational agility will be critically important; priority initiatives should include both quick wins to build momentum as well as the longer-term capability goals. The collections initiatives we are proposing require the introduction of new approaches, such as a digital self-service platform, that will quickly become self-funding.

Many collections heads encounter resistance to modernizing their departments while losses hover around historical averages. Indeed, many report that collections has been largely neglected as product revenues have expanded. We argue that this state of affairs must change. From "trough to peak," losses rose 250 percent in the 24 months after the fourth quarter of 2007. At many institutions, meanwhile, implementing a major IT project (such as a collections transformation) can take 12 to 18 months. Even with a sound plan of action (such as that described previously), many institutions will lack implementation capabilities, leaving collections operations extremely vulnerable. By failing to digitize their collections operations, these institutions risk potentially crippling losses in a future downturn. But if they start now, they could have a largely transformed shop within 12 months.

The global economy has been emitting mixed signals of late, prompting a fair amount of analyst speculation about an impending downturn. One need not guess at the "estimated time of arrival" of a recession, however, before investing in a smart, digital-forward collections transformation. The sooner institutions act, the sooner they will reap near-term rewards and be prepared for future uncertainties.

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