Building a Well-Managed Collections Function

As credit losses rise, lenders need to upgrade all facets of their Collections organization, including ERM and Compliance

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Executive Summary

Over the past few years, our Collections practice at 2nd Order Solutions (2OS) has expanded to not just include large banks and credit card issuers, but an increasing number of fintechs, both in the US and abroad. The fintech sector has grown tremendously, and as their customer bases have grown larger, there is an increasing mandate to focus on default management, especially with delinquencies beginning to rise.

The increase in delinquencies across the industry requires lenders to improve loss mitigation strategies, through better risk prediction models, contact strategies, and forbearance tools. But there is an equally important challenge to do so in a well-managed way, since debt collections is fraught with challenging customer experiences, operations and compliance risks, and keen interest from banking regulators. This paper highlights key areas where lenders need to be in line with regulatory requirements, investor sentiment, and customer expectations.

Being effective at debt collections is very difficult, especially in a worsening economic environment. Customers do not want to be behind on their bills, but they find themselves in financial distress for a wide variety of reasons. Getting to the root of a customers' ability and willingness to pay and creating solutions that fit within their capacity is the first order of business for any lender in their attempts to minimize their credit losses.

When credit is worsening, it's reasonable for a credit leader to focus entirely on Collections as the last line of defense against a set of really bad financial outcomes. But even for the most sophisticated lenders, Collections is a web of complex processes, regulations (many of which are outdated) and challenging customer experiences.

In this paper we provide a roadmap for where the difficulties and pain points lie. We start with a framework for the root causes of complexity within Collections, provide a variety of examples, and suggest a set of important first steps to make Collections a more well-managed part of the lending lifecycle.

Overview – Root causes of complexity

Complexity comes in many different flavors

Inherently complex business functions	Working with third parties to deliver outcomes
Complex regulations creating executional challenges	Reputation/Brand concerns

Inherently Complex Business Functions

Many of the highest profile processes within Collections are maddeningly complex. While most complexity scales with the size of the business, some processes have table stakes that are high regardless of the size of the business. The processes below all fit this description.

Credit Bureau Reporting and Credit Bureau Disputes. When the CFPB was formed, one of the first areas explored was credit bureau reporting. They argued that Credit Bureau Reports were full of inaccurate information. No one wants to be reporting bad information. It is just hard to not only provide accurate data, but to also send it to the bureaus in a manner such that the bureaus will reflect the right data attached to the right consumer. This is one of the most nuanced and complex functions lenders perform.

Bankruptcies. There are ninety US Bankruptcy Courts working with consumers across the US who are seeking Bankruptcy protection. There are many obligations lenders have and many different steps that must be taken as part of the process. Getting on the wrong side of the Bankruptcy Judges or Trustees can lead to dire consequences for lenders.

Estates. Dealing with the death of a loved one can be overwhelming. The aftermath for their financial accounts is generally not top of mind for the families, but is something that has to be resolved by lenders in a compassionate and well-managed way.

Agent Incentives. It is a common sentiment in managing front line operations that "you get what you incent". This sounds easy, but in fact, requires a lot of thinking and adjusting to get right. Most every incentive plan leads to unintended consequences. The key is to monitor incentive plans closely, and iterate to get closer to "right".

Working with Third Parties to Deliver Outcomes

It can be overwhelmingly difficult to get your business operations aligned to execute as intended. It is even harder when you are leveraging other companies to achieve your business intent. Outsourcing is often inevitable, though, as it becomes impractical (or at least suboptimal) to do everything yourself. Managing third parties is full of risk in general. This is heightened when the functions being outsourced are also inherently high risk.

Litigation. Suing customers to get resolution on unpaid debt is a very effective tool, but it requires attorneys who are licensed by each state. Even a modestly sized litigation program involves dozens of third parties. There are national attorney networks who specialize in overseeing each law firm, but then you enter the realm of "fourth party risk" where your suppliers are managing suppliers. The dispersed nature plus a legal system that varies widely state to state makes this a very challenging process to manage.

Repossessions. Secured lending is not really "secured" if you do not have any means of liquidating the asset. For auto lending, you need some way to obtain the vehicle. Customers are not generally very happy to have their cars seized, though. Finding the right repo partners with the right controls in place is critical.

Debt Sales. There are many nuances in debt sales that are well known by debt buyers, but can catch the sellers by surprise, especially lenders with less experience and expertise in Collections. The old poker saying is that if you do not know where the sucker is at the poker table, grab a mirror. One of the seemingly attractive aspects of debt sales is that by selling, the lender can "sell it and forget it." Surprise! There are many post-sale exception processes, like buybacks, bankruptcy-related headaches, and media requirements that create additional work for the seller.

Complex Regulations Creating Executional Challenges

Laws and regulations usually have good intentions. Unfortunately, these laws and regulations generally aren't written (or enforced) by people who deeply understand the second order impacts of their requirements. There are also situations where it is not politically prudent to overturn or change laws that no longer meet their original intent. This creates complexity and risk for the lender.

Reg F. Reg F was published by the CFPB in November, 2020 to clarify and modernize the FDCPA regulations that apply to debt collectors. The current version of the regulation applies explicitly to third-party debt collectors (e.g., Recoveries agencies), and not to creditors, though many creditors have chosen to voluntarily comply. The regulation went into effect November 30, 2021, and places additional restrictions on outbound contacts to include:

- 7x7x7 Rule – debt collectors may not call customers more than 7 times within 7 days. After talking with a customer, debt collectors must wait an additional 7 days to resume calling.
- Debt collectors may not attempt to contact a customer at a known place of employment either through phone or email
- Limited contact messaging rules have been further clarified e.g., some voicemails are subject to Reg F contact rates and some are not depending on content
- Customers have the ability to specify what days/time they should not be contacted and have the ability to opt out of receiving messages for any or all channels

Regulation F has no specific frequency standards for emails or text messages, but they are still subject to the general standards of harassment. Navigating phone call frequency combined with emails and/or text messages in the same week must be a part of a thoughtful outreach strategy.

TCPA. TCPA is a 1991 law that places restrictions on the use of fax machines and auto-dialers. 2023 is very different technology wise that 1991 and many elements of TCPA are based on concerns that are no longer valid. Unfortunately, politicians and regulators do not want to have their name attached to new legislation that removes restrictions or fines from "robocalls". The law makes it challenging to contact your customers without risking large fines from class action lawsuits. It's a needle that can be threaded, but one must do so carefully.

Spamhaus. The email industry tried to police itself, and as a result Spamhaus was founded in 1998 as a not-for-profit company whose mission is to track and stop email spammers. The intentions are positive, but legitimate businesses can get caught in their nets. Legitimate businesses need to understand the constraints of Spamhaus in order to not run afoul of it. In short, businesses can be shut out of being able to email if they are not informed of the rules and careful in following them. This is not primarily a collections issue, but a company facing Spamhaus email blocking is limited in all aspects of email communications.

Reputation/Brand concerns

Operational breakdowns create Reputation Risk and hurt your brand. Most of these are the sum of the sentiment of the individual customer impacts. Others, though, become more public as your business gets bigger. Regulatory enforcement actions and lawsuits are more visible black eyes. CFPB complaints are something worth taking seriously both individually to find opportunities to eliminate corner cases in your operations and policies, and as a means of understanding where you are getting better or worse in aggregate. There are best practices in managing CFPB complaints that are great to adopt.

Being delinquent has an emotional impact on your customers. That can make them more likely to complain about any breakdowns or gaps to reporters, the CFPB, AG offices, or their political representatives. Unfortunately, rising delinquencies also raises the volume on these types of complaints. It is definitely preferable to address any possible future breakdowns BEFORE you are in the middle of a period of high delinquencies.

Conclusion

The complexity of managing a Collections practice that is effective across all of these dimensions can be daunting. There are basic steps, though, that you can take to help start down the path to a more compliant practice. Here are a few critical ones:

Hire a dedicated Compliance advisor for Collections: We hope that this paper illustrates the compliance challenges of managing Collections. A dedicated Compliance advisor with deep Collections expertise is essential to preventing trouble in the future.

Leverage suppliers for the more complex functions: Outsourcing brings risk associated with managing third parties, but if you choose the right suppliers that is more than offset by their subject matter expertise. An easy place to start is to select suppliers who support large banks and have had their work scrutinized both by the large banks and their regulators.

Invest heavily in monitoring: Fintechs often lack Collections expertise, but typically have more flexible data and MIS environments than many of the big banks. Collections monitoring should focus on roll rates, liquidation curves, etc, but also on many of the risks highlighted in this paper.

Please feel free to contact us if you'd like to see some examples or additional details of anything we have discussed within this white paper. 2OS leaders have directly managed all of these complex functions. We know both the tactical measures taken by large banks to stay out of harm's way as well as the spirit of what is needed so that you can scale solutions to match the maturity and resources of where you are today. We welcome the opportunity to support you as you build out your Collections infrastructure.

Acknowledgements

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Jonathan Stalls - Senior Advisor at 2^{nd} Order Solutions and former senior executive at Capital One. At Capital One, he was one of a handful of Senior Credit Officers and he leveraged that analytical skill set in roles spanning credit risk, large scale operations (team of 17,000 associates), and risk management. Most recently he was the Head of Enterprise Risk Management. In this role he successfully led the work across all divisions to address two Consent Orders involving deficiencies in overall Risk Management. The remediation spanned over three years and involved rethinking and enhancing most aspects of Risk Management. There was a particular focus on risk identification, building and testing controls against these risks, and building out change governance processes.

Dave Wasik – Partner at 2OS and former senior executive at Capital One with over 25+ years of experience in consumer credit. At 2^{nd} Order Solutions, he has led > 50 engagements spanning the full credit lifecycle with a particular focus on Collections and Loss Mitigation. Dave also led Collections and Recoveries for Capital One's card and personal loan business during the Great Recession and was one of a handful of Senior Credit Officers while at Capital One.

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strategies, identifying and developing customer personas and journeys, and expanding offer management suite, structure, and fulfillment across top 10 banks, regional banks, and fintechs. Prior to joining 2nd Order Solutions, Justin led large internal and external Operations teams at Capital One and Affirm.

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About 2OS

2nd Order Solutions (2OS) is a leading credit risk advisory firm that specializes in solving the world's most challenging credit problems. 2OS was founded 12 years ago and consults to a wide range of banks, card issuers, fintechs, and specialty finance companies in the US and abroad.

2OS has deep experience with lending businesses across Card, Auto, Small Business, and Personal Loans, at all points in the credit lifecycle. 2OS partners have vast expertise in all aspects of Collections, both as operating executives and as consultants.