

Deloitte.

Collections 3.0™

Bad debt collections:

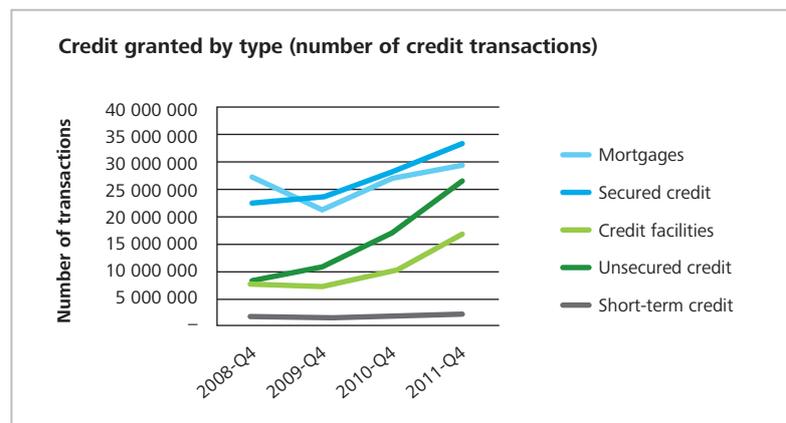
From ugly duckling to white swan



Outgrowing the ugly duckling

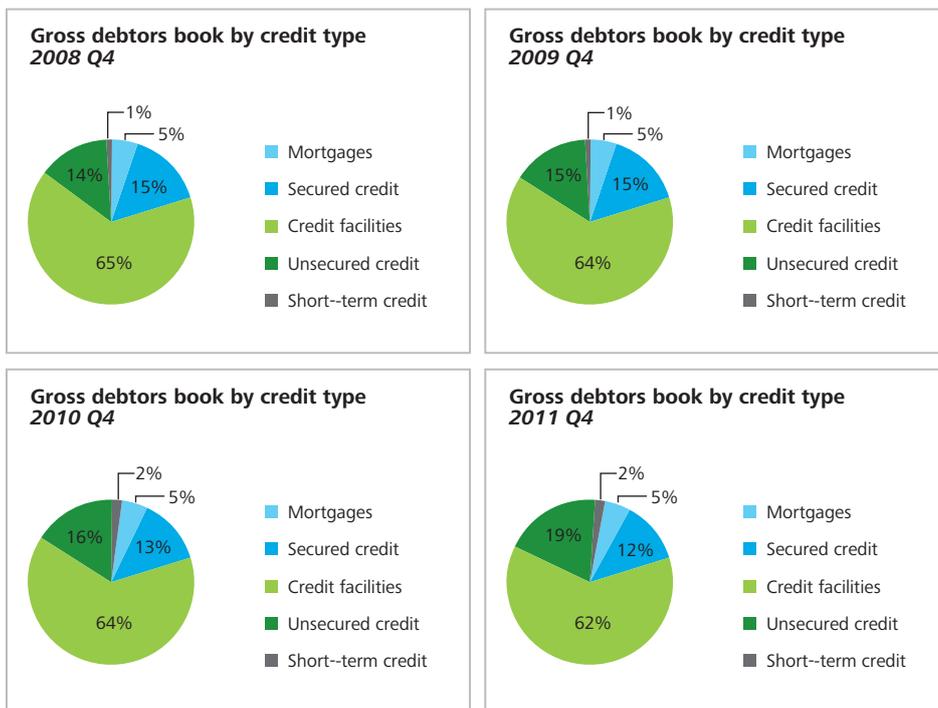
The consumer lending environment in South Africa has become materially more competitive. Relatively new lenders are gaining a stronger foothold in the market and competition from non-traditional lenders' such as retailers, is becoming more common place. Customers in turn are not loyal to one lender and have multiple credit relationships, which has pushed many lenders to reconsider their collections strategy. To put this into context, it was recently reported that there are now 5.8 million more credit active consumers than there are people employed in South Africa, indicating that consumers are likely to have more than one account. Based on comments by some financial research analysts, it is likely that many consumers have over four accounts¹.

There has been an upward trend in the growth of credit transactions over the past few years and this trend is likely to continue as the economy grows. While, credit extension has not been as aggressive as it was before the introduction of the National Credit Act the growth seen is substantial enough to require an effective collections strategy.



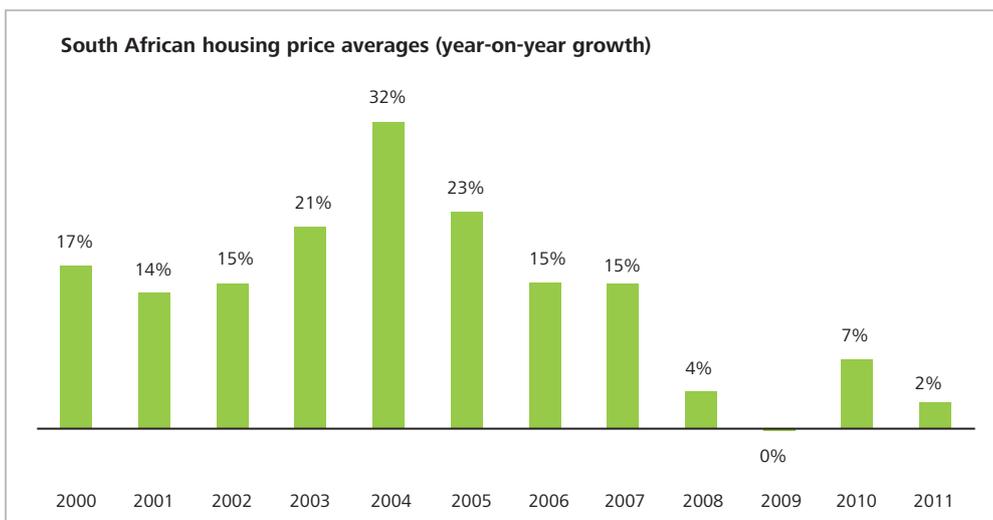
Source: National Credit Regulator

¹ BNP Paribas Cadiz Securities. May 2012. Moneyweb



Source: National Credit Regulator

Unsecured lending as a share of overall credit exposures has increased over the past four years as a result of increased lending.



Source: ABSA. January 2012. House Price Indices

With a slowing in South African housing price growth, reliance on security to mitigate credit losses is no longer the only collection strategy.

Lenders are increasingly looking to gain a competitive advantage through the introduction of market leading risk-based collections strategies and operations.

Collections 3.0™

A risk-based collections strategy encompasses the following key areas:

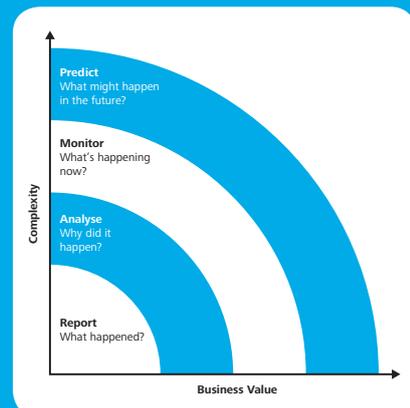
- **Insight from sophisticated behavioural models.** Predictive analytics improve decision making and efficiency by analysing a wide set of customer data to determine the risk level of each account and/or customer, and therefore the most appropriate treatment strategy. This operational strategy aims to ensure that the right treatment and mechanism is used at the right time and at the right cost for each account or customer segment.
- **More efficient, effective processes.** Increasing the automation of collections activities make collections processes significantly more efficient and effective. Organising activities by the risk level of accounts and customers adds to the efficiency gains with low value activities automated and high value activities aligned to the most experienced collectors.
- **An extended business model.** External data providers and debt collection agencies are increasingly being used by successful organisations
- **Enhanced reporting.** Real-time metrics captured in an executive dashboard can improve management visibility of performance and thereby ensure more responsive and informed decision making.
- **Alignment across the credit lifecycle.** Aligning sales and marketing, finance, risk management, pre-delinquency, collections and recoveries functions ensures that the lessons learnt from each function and credit lifecycle stage are shared across the organisation to minimise losses and maintain control.
- **A robust technology infrastructure.** Underpinning all these enhancements is a strong technology infrastructure. Successful collections departments use data mining to assist in segmenting the portfolio and developing the predictive analytics model. They have a well-developed capability to rapidly develop and deploy these predictive models and strategies. They employ decision engines that automatically determine the appropriate treatment strategy for each account/customer. Finally they have workflow systems that reduce costs by automating the collections activities driven from decision engines.



The Collections 3.0™ model

What are predictive analytics?

An organisation's data is full of potential. Stored throughout the business, is a wealth of possibilities. Leading financial services providers recognise that a better understanding of data (particularly as a predictor of the future or as an identifier of existing issues) can create new opportunities and make a significant difference to managing performance. Predictive analytics is a set of statistical tools and technologies that use current and historic data to predict future behaviour.





- **More accurate metrics.** Some institutions are moving beyond traditional measures, such as total rands collected and cost to make a call, to employ “cost to collect R1” metrics that more accurately measure the return on collections spending, and facilitate more robust decision making.

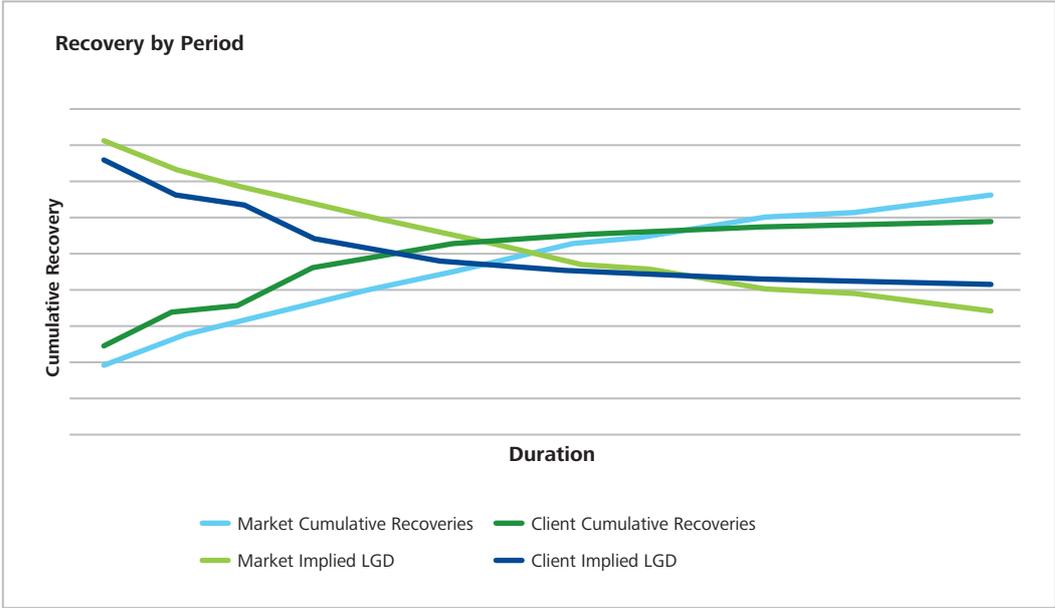
Currently, certain financial institutions are faced with under-performing collections and recoveries functions due to general under-investment over the past few years in the function, in an effort to lower costs.

Ignoring collections, as though it were the ugly duckling, has resulted in these financial service providers having out of date systems, data and skills in this function of the business. Collections functions have also generally been viewed as a cost centre, rather than a revenue recovery centre, and have therefore not received the necessary investment required to enhance efficiency and effectiveness, and in so doing have reduced the ability to further increase profitability and performance. Combining these concerns with new consumer regulation such as Treating Customers Fairly and the Consumer Protection Act and risk-based regulations such as Basel II and III has created the need for lenders to adopt a more risk-based approach to collections. Those lenders that do embrace risk-based collections gain a significant ‘first mover’ advantage through enabling increased collections, better credit decisions, and reduced operating expenses.

Finding the swan hiding in the data

Most financial service providers find that their collection efforts are inefficient relative to the experience of the global market, which indicates that efficiencies can be found across the entire collections lifecycle from pre-delinquency to write off and recoveries. If financial service providers with inefficient collections functions continue with their current collection strategy, collectable balances older than fifteen months will continue to provide minimal return. These financial service providers will also have difficulty in determining whether the cost of collection outweighs the return on these collectable balances.

In an effort to assist in realigning the collection and recovery function Deloitte has developed the Collections 3.0™ approach. This approach, which encompasses both a quantitative and qualitative component identifies areas of improvement within the collections and recoveries space, as well as comparing completed accounts' (i.e. non-performing accounts that have either cured or written-off) loss figures against industry peers. Collections 3.0™ involves the processing and transforming of default data for various purposes and by using a standard loss-given default (LGD) calculation to run the data, the losses experienced on the completed accounts and trends can be analysed over time.



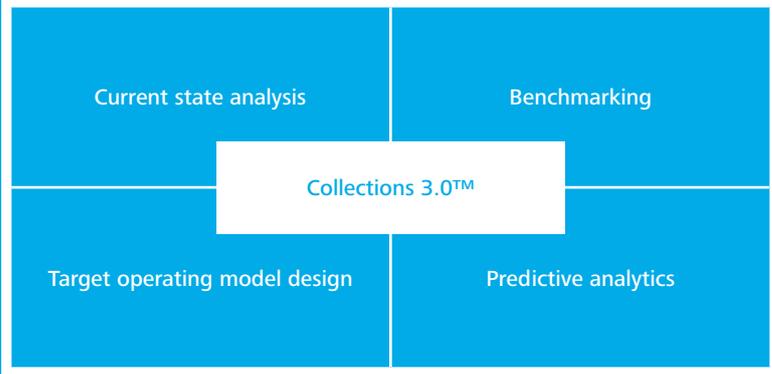
Cumulative recoveries on a lender's defaulted book. (fictitious data)

The completed accounts' loss figures can be compared across the banks and from this, various metrics can be extracted, including for example:

- Write-off policy impacts
- Debt-counselling impacts
- Impact of restructuring
- Compared write-offs over time

What is Collections 3.0™?

Collections 3.0™ involves a qualitative and quantitative combination of analysing the current state of a collections and recoveries function and benchmarking it against peers, thereby enabling efficiency gaps within the function to be revealed. Then through the use of predictive analytics a new and enhanced target operating model can be developed and optimised for the collections and recoveries function. This target operating model can be tailored to the credit base, enabling increased efficiencies to be realised.



The Collections 3.0™ difference

The qualitative aspect of the Collections 3.0™ approach also involves the use of a proprietary tier structure model for collections and recoveries. This tool facilitates quick and effective comparison of the relative sophistication of an institution's collections organisation. The comparison is made across a number

of high level elements, each of which assessment is based on a more detailed analysis of lower level aspects of performance. It allows mapping of "as is" and "to be" positions and so can be used to illustrate a programme for change to transform the collections organisation. The following table illustrates the continuum of practice between traditional collections and the risk-based Collections 3.0™ approach.

High level Tier Structure Model (TSM) for collections and recoveries					
	Traditional collections		Transitional collections		Risk-based Collections 3.0™ approach
	Tier 1	Tier 2	Tier 3	Tier 4	Tier 5
Strategy and policy	No formal co-ordinated setting of a credit risk management strategy (including collection and recoveries).	A strategy for credit risk management set at a Group level is not clearly linked into business strategy.	Risk management strategy is communicated and accepted across the business units, with clear objectives in line with business strategy.	The strategy is adopted by all business units and it is integrated into all risk classes. Strategy is dynamic in nature and focused on specific customer characteristics.	The strategy is totally embedded into the businesses and fully integrated into other risk classes. Champion versus challenger methodologies fully embraced.
Risk governance and organisation	Roles and responsibilities are not defined or clearly allocated for credit risk. No clear role for risk within the organisation.	Some roles and responsibilities are defined in a co-ordinated fashion – generally focusing on Group centre. Risk is recognised as a clear role in the organisation.	Individual roles and responsibilities are aligned to the individual components of credit risk. Risk primarily seen as cost centre.	Duplications are eliminated. There is clear role and responsibility allocation between Group centre and business units. Risk increasingly seen as profit centre.	There is fully optimised and cost efficient model in place with all responsibilities clearly defined. Risk is seen as business enabler.
Collections and recoveries definitions	No clear and universal definition of collections and recoveries terminology exists.	Collections and recoveries definitions are defined in some business units but not others.	Multiple definitions of credit risk exist across the organisation, with no clear distinction between fraud, credit abuse and credit risk.	There is a single set of definitions but they are applied or interpreted in an inconsistent manner across the organisation with respect to specific measure and timeframes.	There is a single fully integrated set of definitions used consistently across the group.
Processes and methodologies – qualitative	There are limited formal processes for management of credit risk, uncoordinated across the organisation.	There are Group-defined processes for managing credit risk, but which lack robustness and business buy-in.	There are methodologies and tools which are consistently applied by the business units.	There is a complementary and integrated suite of tools to cover each aspect of the process.	An optimal control framework, including full cost vs. benefit analysis of the methodologies employed.
Processes and methodologies – data and analytics	No formalised or co-ordinated collection of credit risk data.	There is some tracking of credit risk data, although not complete for all business lines.	There is complete coverage of loss and transaction data across all business units. Internal data predominantly used.	External data used to supplement internal data. Loss information collected is largely accounting based and customer contact information poorly structured.	The organisation has complete economic loss data, seamlessly incorporating internal and external data, including detailed customer contact information.
Processes and methodologies – quantitative	No formal quantitative measurement of credit risk (collections and recoveries elements).	Some form of credit risk (collection and recoveries elements) quantification takes place using collections scorecards.	Credit risk (collections and recoveries elements) is quantified using collections and recoveries scorecards.	Risk quantification models take into account alternative communication media and strategies.	Risk quantification models used to optimise collections and recoveries performance by considering all tools and strategies available.
Communication and information flows	There is no formalised management reporting of credit risk and an unsophisticated customer communication strategy.	Some reporting formally defined for management at a Group level. Customer communication strategies are more formalised but still unsophisticated.	Reporting supports decision making and the proactive management of credit risk, used by Group and business units. Multiple communication media used.	Reporting is embedded in the business's day-to-day activity and is integrated across risk class. Communication media varied and determined by scorecards.	Reporting is fully automated and real time. It is fully integrated with other risks. Sophisticated multiple communication media can be employed.
Skills and resources	There are only a few individuals within the organisation who have necessary collections and recoveries skills.	Collections and recoveries risk management roles are generally populated by individuals with necessary skills.	Collections and recoveries responsibilities within the business units are discharged by individuals with appropriate credit risk skills supported by appropriate training.	High degree of understanding of collections and recoveries skills across the organisation, supported by training, incentive schemes and competency model.	Effective allocation and use of resources efficiently applying the skills sets of existing resources.
Validation and assurance	No formal validation of the credit risk management framework occurs.	Internal audit include the credit risk management framework in their reviews on an ad hoc basis.	Internal audit provide formal assurance to the Board of the validity of all aspects of the framework.	Stress tests of qualitative and quantitative factors to assess the future validity of the risk management framework.	The credit risk framework contains embedded validation and assurance on a real-time basis.
Continuum of practices					

Transforming from ugly duckling to white swan

Deloitte has been working with a number of clients across the globe for the past seven years to transform their collections and recoveries operations. In Ireland, we have spent the last 18 months transforming a bank's collection function with significant results. When we began working with the client the economic environment in the country was deteriorating rapidly with unemployment increasing and housing prices falling. In the political environment the "blame the bankers" concept was resulting in trade unions encouraging their members to boycott making mortgage payments. There was also an increased

swing towards consumer protection in the context of collection strategies but also increased occurrence of "strategic debtors".

The original business case for the transformation was to improve efficiency by 25% and effectiveness by 15%. By February 2012, the Collections 3.0™ transformation journey enabled efficiency improvements of circa 35% and effectiveness of circa 22% to be realised at a time when the credit environment was still worsening.

A business case for collections transformation: Deloitte's experience with financial service providers in Ireland

What needed to be addressed?		What was the result?
Strategy, Appetite and Policy Champion versus challenger strategies were not embedded.	>	Strategy, Appetite and Policy Champion versus challenger strategies became embedded into the collections culture and within reporting, including in standard management information (MI) packs. Collections strategies became fully aligned to organisational risk appetite.
Risk governance and organisation There was a lack of end-to-end credit risk lifecycle alignment.	>	Risk governance and organisation Greater interaction between the collections, recoveries and the credit risk function (covering acquisition and account management processes).
Delinquency definition Internal definitions were not aligned to regulatory definitions and confused the strategy implementation.	>	Delinquency definition Definitions aligned to regulatory definitions became widely documented and understood.
Processes and methodologies – Qualitative There was no evidence of consistent process implementation that was aligned to strategy	>	Processes and methodologies – Qualitative Collection processes became fully documented and embedded into collection systems, increasing process and regulatory compliance and efficiency of collections operation.
Data, Analytics and IT An under-investment in infrastructure meant it was fragmented which limited the efficiency of the operation.	>	Data, Analytics and IT The integration of technology and data infrastructure allowed greater strategy automation and associated reporting and MI benefits.
Processes and methodologies – Quantitative There were no quantitative models in place within collections.	>	Processes and methodologies – Quantitative Risk based collection models embedded into collections processes.

<p>Communication and information flows Poor data infrastructure limited the timeliness and accuracy of MI.</p>		<p>Communication and information flows Robust communication plans were put in place, and MI was transformed to provide both operational and financial performance at sufficient enough granularity for on-going strategy development and post implementation reviews.</p>
<p>Skills and resources Key skills had been lost since last recession, and no robust training and development plans had been put in place.</p>		<p>Skills and resources Training and development plans were put in place. A competency framework was developed and the operating model became aligned to the skills set of teams.</p>
<p>Validation and Assurance Validation and assurance had been undertaken on ad-hoc basis by Internal Audit and Compliance.</p>		<p>Validation and Assurance A specialist collections compliance manager was recruited, and organisational design changed to include a training and development manager responsible for call listening and process assurance, which has increased the control framework.</p>

The Collections 3.0™ transformation journey

Phase 1:

Collections and Recoveries Benchmarking

Review of the entire collections and recoveries function including its interaction with other functions in the organisation (including risk management, legal, compliance, internal audit and customer services). This facilitates the establishment of an as-is review and maturity assessment of the current environment in light of the Tier Structure Model (TSM) (qualitative benchmarking). The relative strength of the collections and recoveries function can also be achieved through a quantitative benchmarking exercise, using market data to standardised internal Deloitte models (quantitative benchmarking).

Phase 2a:

Target Operating Model Development

This phase incorporates a thorough review of existing operating model and the development of a clear vision for a Target Operating Model (TOM) for collections across various domains such as strategy, processes and governance. This enables the organisation to establish a coherent vision for their collections and recoveries function.

Phase 2b:

Quick Wins and Soft Skills Transformation

Instigation of a "Collections and Recoveries Transformation Programme" relating to quick wins (i.e. those matters that will require little investment, but offer a large return in the short term) that is designed to focus initially on improving the "softer" skills and implementing quick wins within the collections and recoveries functions.

Phase 2c:

Support Infrastructure Transformation

Efficiency and effectiveness improvements within the collections and recoveries function may require some major changes to the data and IT infrastructure of the lender, and specifically better integration of the lender's systems.

Phase 2d:

Management Information (MI) transformation

Following on from data and infrastructure developments, it may be necessary to devise a comprehensive set of collections metrics and reports to support efficiency and effectiveness improvements in their collections operations and associated strategies. This will cover financial MI, collections MI, operational MI and customer and product MI.

Phase 3a and b:

Strategy Transformation (including late arrears)

Improvement to the lender's data and IT infrastructure may result in a major shift in the effectiveness of its operations. This is as a result of greater automation of low value processes, and a more standardised approach to collections strategies. However in order to improve the effectiveness of the collections operation, it is important that the appropriate strategy is designed, managed and developed first.

Phase 3c:

Predictive analytics transformation

In order to fully optimise collections it is important to incorporate behavioural analytics into the collections and recoveries function. This includes the identification of customer-level scoring drivers for pre-delinquency, recovery and litigation levels. If necessary, the lender may also wish to develop Basel III and IAS 39 compliant models.

The appeal of the swan cannot be denied

Better understanding as to what drives recoveries not only allows management to increase the bottom line, but also provides a strategic mechanism to further entrench market share, achieve business growth and enhance shareholder returns. The outcomes of

improving collections processes can have additional, frequently unexpected benefits such as deeper customer insights, which in turn enable better and more efficient collections strategies.

Benefits of adopting the Collections 3.0™ approach			
Through incorporating a risk-based collections strategy, many of our financial services clients have been able to realise tangible benefits such as:			
Improvements of up to 20% in Rands collected	Reductions of up to 30% in cost to collect	Payback on investment in technology usually within 12 months	Charge-off reductions of up to 10%
Enabling roll-rate declines	Identifying potential risks to the business	Improving the efficiency and effectiveness of the collections function	The ability to make comparisons against benchmark measures
Effectively comparing operations against competitors using consistent definitions	Improved customer retention, by eliminating calls to those likely to pay without contact	Reduced call volumes, making more efficient use of call centre resources	Identifying new opportunities for revenue streams as well as cost reductions
In addition to the bottom line benefits available through investment in risk-based collections, there are substantial intangible brand-enhancement benefits from which clients could benefit. Through better understanding who the most risky collections customers are, and through better tailoring strategies for contacting them and recovering in-arrears funds, lenders can dramatically reduce unnecessary or mis-timed customer contact. This has enabled our clients to realise the following intangible benefits:			
Facilitating a better marketing strategy through a more targeted approach	Improve customer retention efforts through better customer understanding	Understanding the market trends and how they impact on the business	Overcoming obstacles to adjust to new trends

Become the swan

Due to the wide uptake of credit in South Africa, the collections function is increasingly becoming a key focus to any lending organisation. To grow out of the ugly duckling and embrace the swan, requires an understanding and a willingness to optimise collections strategy, governance systems and data. Aligning this knowledge throughout the organisation is important. The Collections 3.0™ approach is emerging, which combines predictive modeling techniques with the increased productivity achieved by automating collections activities, improving metrics and realigning the organisational structure.

Lenders that migrate to these greater levels of collections sophistication will capture substantial benefits in lower operating costs, a higher rate of promises kept, more Rands collected, greater brand loyalty, and more satisfied customers. An institution that creates a truly risk-based collections organisation will achieve a significant advantage in an ever more competitive industry.



Contact us



Damian Hales
Partner
dhales@deloitte.co.uk



Pravin Burra
Director
pburra@deloitte.co.za



Derek Schraader
Director
dschraader@deloitte.co.za



Jonathan Sykes
Senior Manager
jsykes@deloitte.co.za

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

"Deloitte" is the brand under which tens of thousands of dedicated professionals in independent firms throughout the world collaborate to provide audit, consulting, financial advisory, risk management, and tax services to selected clients. These firms are members of Deloitte Touche Tohmatsu Limited (DTTL), a UK private company limited by guarantee. Each member firm provides services in a particular geographic area and is subject to the laws and professional regulations of the particular country or countries in which it operates. DTTL does not itself provide services to clients. DTTL and each DTTL member firm are separate and distinct legal entities, which cannot obligate each other. DTTL and each DTTL member firm are liable only for their own acts or omissions and not those of each other. Each DTTL member firm is structured differently in accordance with national laws, regulations, customary practice, and other factors, and may secure the provision of professional services in its territory through subsidiaries, affiliates, and/or other entities.

© 2012 Deloitte & Touche. All rights reserved. Member of Deloitte Touche Tohmatsu Limited

Designed and produced by Creative Services at Deloitte, Johannesburg. (000000/dbn)