STAYING AHEAD OF THE CURVE: ADAPTING DEBT COLLECTION FOR INCOMING CREDIT RISKS

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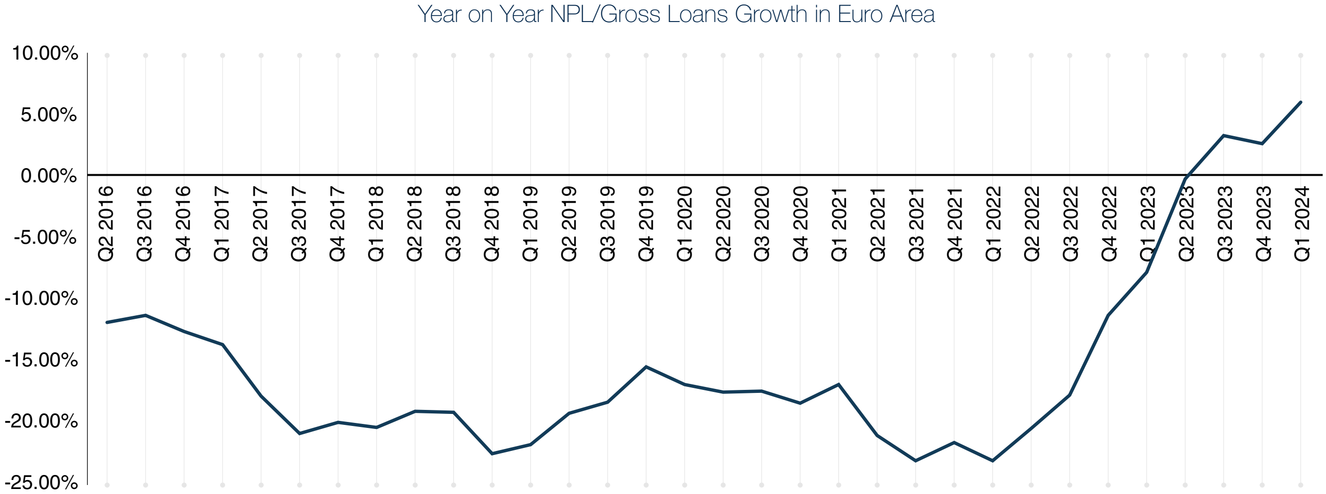
After a prolonged period of relative stability, credit quality is once again emerging as a potential sore point for financial institutions across Europe.

For the past decade, a benign macroeconomic environment and banks' efforts to clean up their balance sheets after the global financial crisis have kept loan delinquencies in Europe at historically low levels.

Now, continued higher interest rates and living costs, combined with weakness in jobs markets across the region, are pushing a growing number of households to the brink of financial distress. This is raising the prospect of higher delinquencies in retail loan portfolios, as many consumers struggle to keep up with their debt repayments, particularly those in the lower and middle-income segments.

In one sign that the credit cycle may be about to turn, non-performing loans (NPLs) have started to tick up last year, reversing a decade-long trend. Recent data from the European Banking Authority (EBA) reveals a continued rise in NPL among European banks, with a significant acceleration in the first quarter of 2024. The period saw 7.6 billion euros of additional NPLs, almost 3.5x the increase registered in the last quarter of 2023, according to an analysis by Scope Ratings[1].

Figure 1: Year-on-year NPL ratio growth in Euro area



Source: Statista, A&M analysis

[1] Source: "EU Banks NPL Heatmaps Q1 2024 Data." Scope Ratings, July 8, 2024.

In the second quarter, Netherlands, Germany, Finland and France saw quarterly increases in NPL ratios. Corporate NPLs accelerated notably in Germany and Austria in Q2 versus the same period of last year, underscoring rising distress in the corporate sector that may soon impact the job market and households' budgets. In Germany, stage 2 loan ratios have also increased significantly, reaching 12.8% in June 2024, from 10.1% a year earlier and just 5% in December 2019, EBA data shows.

RETHINKING COLLECTION OPERATIONS

Banks have a crucial opportunity to rethink and strengthen their debt collection strategies to stay ahead of these incoming asset quality risks.

In fact, traditional collection methods used by most lenders today could exacerbate losses and defaults in a deteriorating credit environment. For instance, many still rely heavily on manual, paper-based processes for collections, making it difficult to scale operations and respond swiftly to the increasing volume of at-risk accounts.

Most institutions also continue to depend on outbound call-centres for communication – an increasingly ineffective approach given customers' preference for digital channels. Additionally, many banks are not fully leveraging data to identify inefficiencies or leakages in collection, limiting their ability to optimise recovery efforts.

Clearly there's an urgent case for change, but how do banks begin to address the challenges with their collection operations?

A&M's experience shows banks can unlock significant unrealised value through the optimisation and digitalisation of their collection strategies. Our approach consists of two distinct phases:

PHASE 1: OPTIMISATION "QUICK WINS"

We run a diagnostic of as-is collection processes to find near-term optimisation opportunities across three key areas:

Recoveries:
We identify un-managed, under-managed or mis-managed customers to enable clients to quickly tap into new sources of cash flow.

Parameters and processes:
We audit the institution's processes and IT systems to detect and fix potential IT bugs, streamline collection processes and propose higher-impact collection strategies.

Campaigns:
To increase repayments and customer satisfaction rapidly, we introduce campaigns that engage defaulted customers early, offer flexible repayment plans and ensure clear communication.

Following this deep dive into the collection process, we apply our recovery benchmark methodology – powered by a database of over 10,000 recovery curves across retail banking products – to the loan portfolios to measure the potential uplift in collections.

Although the extent of the improvement will depend significantly on each lender's starting point, our short-term actions have the potential to boost cumulative collections by more than 20%. These gains can then be reinvested into financing digitalisation initiatives – the second step in transforming collections that we'll discuss next.

CASE STUDY: BOOSTING COLLECTIONS FOR A POLISH NPL INVESTOR AND SERVICER

Challenge: A Poland-based NPL investor and servicer was facing stagnating collections across its 300 portfolios, comprising more than 1 million individual claims. A&M was brought in to perform a detailed review of their strategies, systems and portfolios.

Initial assessment:

We began by thoroughly reviewing the client's database, looking at historical recoveries, current legal stages of claims, amicable tools used and call centre KPIs, among other metrics. We also assessed existing collection processes through process maps and interviews with legal, amicable and field collection teams.

Solution:

Our deep-dive analysis identified critical leakages and mapped out improvement opportunities. For instance, we found that 50,000 claims, representing 40 million euros in loan value, had never been escalated to the legal department, and that 60% of the portfolio had not been contacted for over 30 days. On the positive side, we discovered that discount campaigns were particularly effective, with a strong correlation between these campaigns and repayment rates for consumers aged 25 to 45.

Impact:

Total collections increased by 20% on average in the two years following the implementation of near-term actions based on our diagnostic of mis-managed customers. The introduction of advanced customer activation campaigns, offering discounts for full debt settlements, resulted in accelerated collections for 40% of the portfolio.

PHASE 2: DIGITAL TRANSFORMATION

With consumers opting for digital interactions more often than before, channels like email, SMS, and mobile apps offer more effective means of engagement and higher resolution rates.

Moreover, new data analytics methods have made it easier for lenders to proactively revisit asset quality and collections strategy, an approach that allows for tailored interventions while strengthening customer relationships and supporting regulatory objectives.

As delinquencies rise and the demand for resilient collection operations grows, we believe there is an unexploited opportunity to digitalise collections. A well-conceived digitalisation programme should be driven by the following value creation levers:

Automation of collection processes: Robotics and RPA can assist agents with tasks such as payment processing, setting payment reminders, skip tracing and updating customer records, cutting time and costs as a result.

Digital engagement strategies:
Creating digital journeys for at-risk customers reduces banks' cost-to-serve while increasing their propensity to engage. Examples of a digital engagement approach include the use of real-time live chats to check on customers at every stage of their journey, or self-service options that make debt collection seem less intimidating for the client.

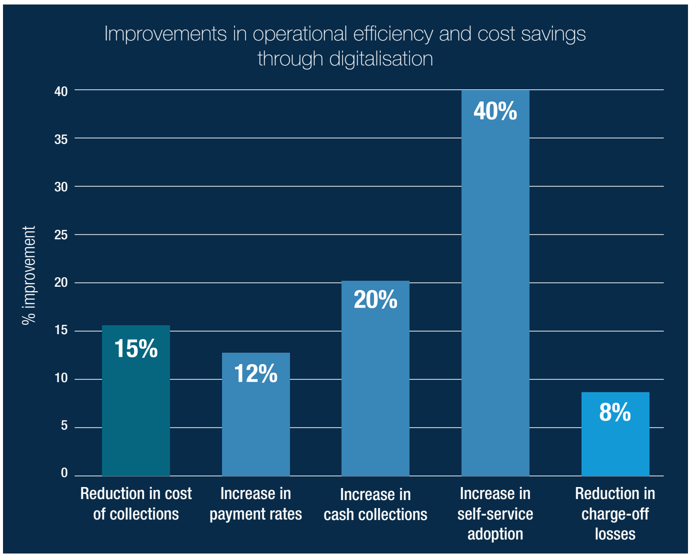
Analytics and AI for better decision-making:
Data analytics and advanced AI/ML tools enables early identification of at-risk customers, improving risk management and allowing for tailored interventions before they enter the collections cycle. Early intervention also builds trust and loyalty, and helps banks align with the regulatory goals of consumer protection and financial stability.

Figure 2: Optimising every step of the way

Stage of the collection process	Pre-collection	Early delinquency	Late delinquency	Recovery	Post collection
Optimisation opportunity		Higher-impact campaign strategies, increased customer engagement at early stage	Deep-dive analysis, segmentation of accounts, prioritisation of high-risk accounts and legal warnings	Identify un-managed, under-managed or mis-managed customers, customer reactivation	Debt packaging, potential pricing and selling support
Digitalisation opportunity	Risk assessment, payment monitoring and reminder systems	Identification of overdue accounts, shift to multi-channel communication	Escalation triggers, penalty management and legal preparation	Legal document preparation and case management	Bad debt write-offs and asset management

STRATEGIC AND ECONOMIC BENEFITS OF COLLECTION DIGITALISATION

Based on our experience with several European banking clients, lenders that have implemented structured digitalisation strategies have achieved tangible business results including:



Source: A&M analysis and research

HOW A&M CAN HELP

A&M's years-long presence in non-performing and sub-performing loans segment in EMEA has yielded a database of over 10,000 recovery curves across retail banking products. Our recovery benchmarking methodology – which covers unsecured consumer loans, credit card loans, telecom and utilities debt – can help you identify inefficiencies and unlock opportunities to uplift the performance of your collection operations going forward.

Our team will also define a strategic roadmap for the digital transformation of collections, focusing on critical areas such as early warning systems as well as digital engagement and automation, with specific goals and timelines. Initial savings generated by quick improvements in collections can fund future investments in back-end digitalisation and other long-term improvement initiatives.

CONTACTS

BERNHARD ENGEL
MANAGING DIRECTOR

bengel@alvarezandmarsal.com

TRISTAN BRANDT
MANAGING DIRECTOR

tristan.brandt@alvarezandmarsal.com

SARA GRINSTEAD
MANAGING DIRECTOR

sgrinstead@alvarezandmarsal.com

NIKOLA AVRAMOVIC
SENIOR DIRECTOR

navramovic@alvarezandmarsal.com

ABOUT ALVAREZ & MARSAL

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With over 10,000 people providing services across six continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth.

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