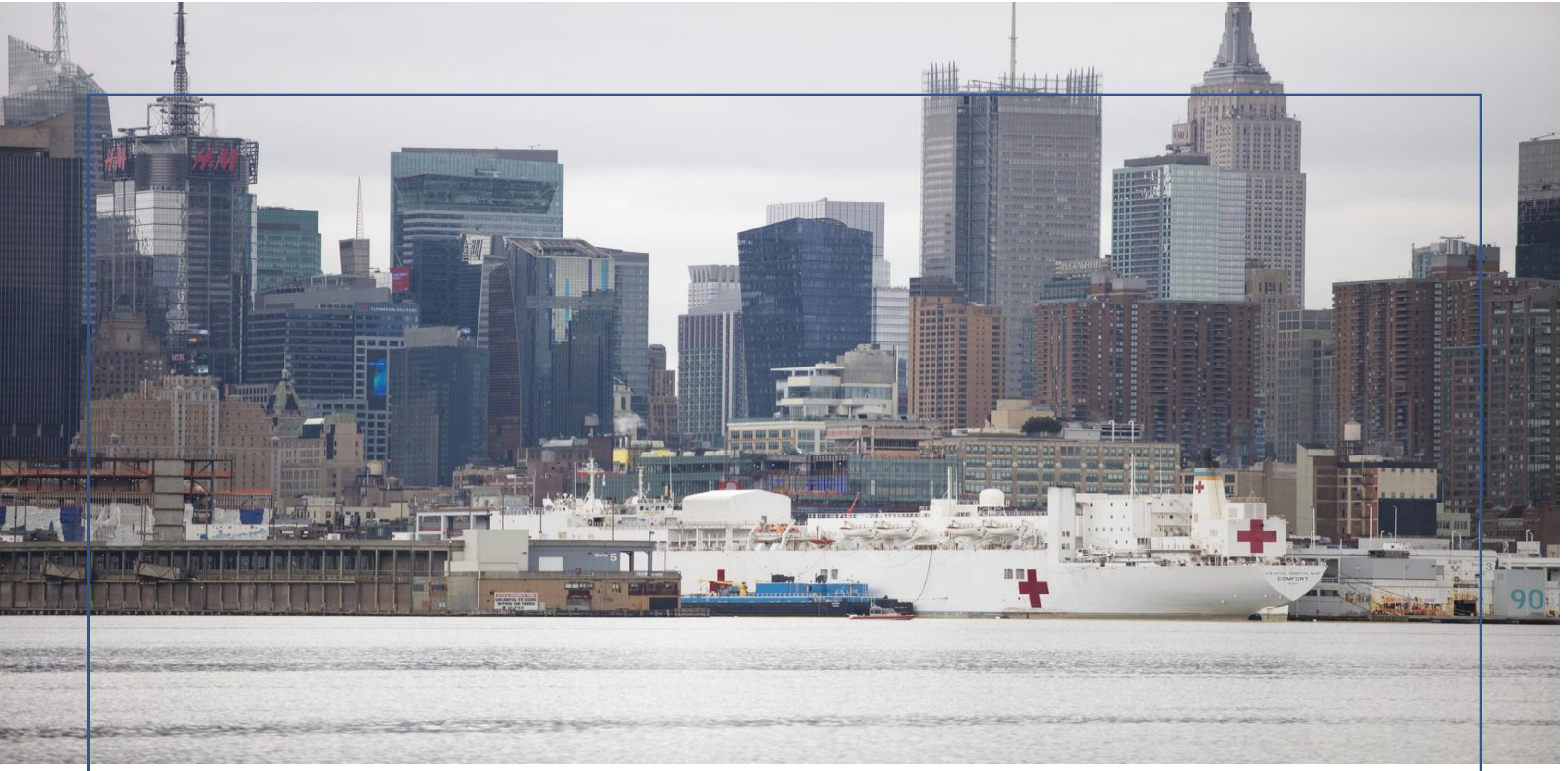

Collections During Crisis: Insights on the Impact of COVID and Strategies for Navigating Its Fallout

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INTRODUCTION

The purpose of this paper is to first identify and answer some of the questions most frequently asked by our clients regarding the fallout of COVID. After that, we examine if the premise holds that, like the mortgage servicing industry at the start of the housing crisis, the commercial accounts receivables industry is using too conservative an option-set for dealing with the fallout of this crisis. The format of the paper is a Q & A style, with standalone sections that present a question and provide observations based on analysis of our data.

In 2008, I left my tenure-track professorship, studying and teaching social psychology and behavioral economics, to accept a position with a technology start-up firm that designed and built workflow systems and analytical models that served the mortgage-servicing industry – just in time for the industry to radically change due to the housing crisis of 2008-2010. Almost overnight, we went from operating as-per-usual, using a decades-old model of default and foreclosure, to having to find ways to mitigate loss on a scale never seen before. Complicating this, customers saw the value of their assets and ability to repay loans drop precipitously, and they had limited recourse under the prevailing industry strategies.

In a striking parallel, a few months ago, I left another stint in academia to join a company in whose value I strongly believe, AG Adjustments (AGA). Just as before, within weeks of my joining, the economy, and the collections industry, is back in a perceived freefall, this time due to COVID.

Of course, the economic drivers of the collapse, the scale of businesses affected and prospects for recovery trajectory are vastly different. Certainly, the commercial accounts receivables and mortgage industries share differences as well.

The two industries are alike in one notable way, though – they use similar strategies for debt recovery. They are also comparable in that most clients and agencies follow prevailing and uniform models of recovery strategy – making full demand, taking legal action if the economics make sense, and only occasionally, without any systematic rationale using settlements and payment plans, relying on partial payments to keep the account open until a debtor receives enough money to payoff the account.

If we can take a lesson from history, the prevailing lack of rationale and overreliance on partial payments represents an opportunity for us to better serve our clients today. During the mortgage crisis, my team worked with one of the country's largest subprime loan servicers to design and implement a greater array of loss mitigation options than was used by the rest of the industry. We did this by analyzing the Net Present Value (NPV) over the lifetime of an investor's loan. Our work indicated that it is sometimes better to offer settlements, payment plans, forbearance, and other more-nuanced options, based on a strategic method rather than the prevailing industry approach.

At AGA, we are in the unique position to help our clients understand where to find these opportunities and deploy them effectively and efficiently. As a first- and third-party commercial accounts receivables management firm that has operated for over 47 years, we have a high degree of visibility into the impact of economic events on business-owners who are dealing with delinquent accounts and the prospect of lower financial projections. We have also invested in systems and methods that allow us to create a recovery approach that is customizable based on our clients' needs, and we want to work with our partners to find the right strategies.

Question 1: How much has COVID affected collections revenue?

We'll start with an easily answered one. First, we split our data on payments into two equivalent pre- and post-COVID samples (*pre-COVID* = Payments received between 2/9/20-3/21/20; *post-COVID* = 3/22/20-4/29/20), using the same clients, collectors and recovery strategy (Full Demand→ Partial Payment→ Legal). What we found is not surprising: **Once businesses began closing due to lockdowns, collections fell 48%**. However, this isn't the full story, leading us to the next question.

KEY TAKEAWAYS (Questions 1-3)

1. Collections have fallen by 48%
2. There are 36% more placements, but their unpaid balances are 42% smaller
3. Collectability is down by 38%

Question 2: What is COVID's impact on placements?

Using the same data as Question 1, we found that **we are actually receiving 36% more placements now than before COVID**. This seems paradoxical on the surface, without consideration of placement amount. Our **post-COVID placement balances have been 42% smaller than before the crisis**. Certainly, some of this may be due to relative difference of placement mix among our clients, but there is a very strong possibility that **clients are holding larger balances until the economy recovers**. As a cautionary note, if this is happening, it could lead to more trouble down the road if the economic recovery is slow. After all, it takes businesses time to rebuild assets even once business improves again, and by that point clients may be competing for wallet-share with other creditors.

Question 3: Have debts really become less collectible?

The answer here is, using traditional recovery strategy (see Question 1), they have. Using the same data as before, we controlled for placement number and value by creating a dollars-collected per dollars-placed metric. Further, we restricted our analysis to cover only dollars collected on accounts placed during each of the time periods. This is the purest measure of the effect of initial collections activity, and it gives us a standardized metric that holds placement numbers and amount constant. Effectively, this assesses the debtor's ability to pay the debt today. These results were striking – **the post-COVID group collected 38% lower dollars for every dollar placed**. This paints a depressing picture for the industry as a whole, but, as the introduction to this paper noted, we believe it represents a tremendous opportunity for forward-looking clients.

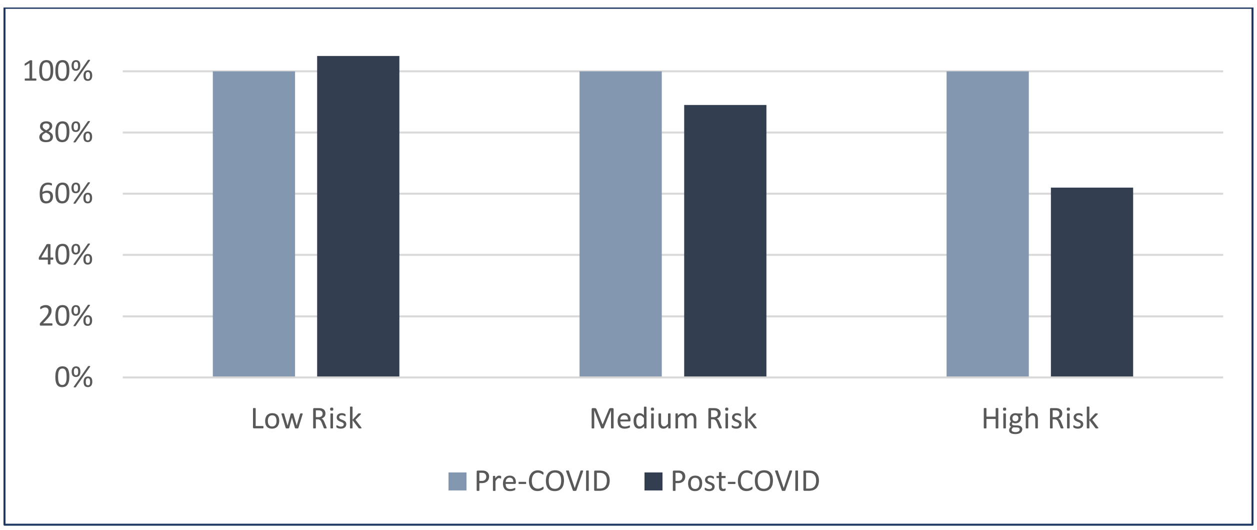
Question 4: Has COVID impacted collectability differently across client segments?

To answer this question, we had to switch data sources. What we were really interested in was whether COVID differentially affects average payment size, based on the level of shutdown risk within a client's segment. Put another way, how great is the difference in debtors' repayment in high-risk segments (*e.g., food service, office products, etc.*) versus lower-risk ones (*e.g., shipping, medical supplies, etc.*)?

To examine this, we collected pre- and post-COVID data from a sample of 14,065 payments across 28 different client segments, then arranged the segments into three risk categories (high, medium, low) based on how likely each segment was to be impacted by the lockdown. Then we compared the average post-COVID payment size within each segment to the average pre-COVID payment size to create a relative *payment size index*. This means that all pre-COVID payment amounts are set to 100% and post-COVID payments reflect a percentage of pre-COVID payments.

As expected, as segment risk rose, so did the impact of COVID, though the relative impact is a bit surprising (*see Figure 1 below*). **Low-risk segments received higher payments, medium-risk segments were not impacted greatly, and low-risk segments, though impacted, did not completely stop making payments**.

Figure 1. Payment size index change based on COVID & Risk Category



KEY TAKEAWAYS (Question 4)

4. COVID's impact on payments depends on its risk to business operations
5. Typical recovery strategies yield less return on effort as segment risk increases

Question 5: Has working remotely affected collectors' efforts on accounts?

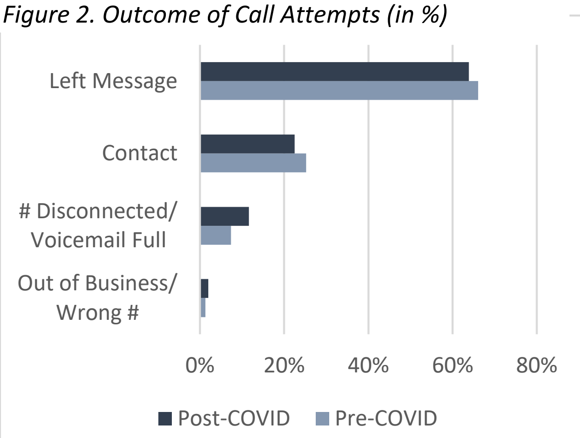
Some clients may be afraid to place accounts due to the impact of work-from-home conditions on collectors. There are a myriad of considerations ranging from large (*How do we ensure collectors can securely access debtor data?, How can we achieve management visibility?, etc.*) to large-but-seemingly-mundane (*What is the process for sending and receiving mail?, Do we have enough company-issued laptops for everyone?, etc.*).

Because AGA uses secure cloud-based data management and systems that can be accessed via encrypted methods, we were able to quickly redeploy our workforce remotely and still have oversight and visibility into work efforts.

Once we enacted our plans and settled our collectors in their remote work environments, our file effort and contact metrics are almost the same between our pre- and post-COVID groups (see Question 1). **Attempts to contact and file reviews per claim metrics were only down by less than 3%** (within the statistical margin of error).

We cannot speak for all agencies, of course, so we recommend that our clients ask for a similar assessment from all their agencies. Certainly, if you place a file, you want to ensure that it is being worked with the same amount of effort, regardless of work conditions.

Figure 2. Outcome of Call Attempts (in %)



KEY TAKEAWAYS (Questions 5&6)

6. With the right plan, agencies can maintain pre-COVID work rates remotely
7. Contact rates can be similar during the crisis, with enhanced skip-tracing practices

Question 6: Have contact rates dropped or differed?

One concern regarding placements during the crisis is that, due to closures or changes in workplaces, it may be more difficult to contact businesses to speak about collection of debt. **Failure to reach debtors is the largest driver of collections failure because contact is upstream from all other collections activity**, making contact rate maintenance critical.

To assess the extent of COVID on contact rates, we randomly sampled account notes for 3,458 files and broke them into pre- and post-COVID timeframes, using the same date ranges as before. Then, we coded the contact results of each attempt made on the file and calculated the ratios of each result by total number of attempts.

As seen in Figure 2, there is some reason for optimism here. **Overall contact ratio has not changed very much**. Businesses have either adapted to remote work or have adjusted operating hours, and we have been able to respond accordingly.

The biggest difference is that there is a **58% rise in numbers have been disconnected or with full voicemail boxes**, meaning the business may be non-operational. However, since the overall contact % has only dipped slightly, that can be overcome with investment in more robust skip-tracing.

Question 7: How has COVID affected conversations with debtors?

Moving down the chain of collections drivers, next we examined how COVID has affected payment discussions once a collector reaches a contact. In other words, how have ability and willingness to pay been affected?

Looking at the contacts in the sample of call data from Question 6, we analyzed the course of discussion via the account notes and coded the conversations by debtor responses for a subset of 871 contacts in the sample. This gave us an indication of the change in contacts' promises to pay.

We also measured debtor reasons for not making a promise to pay in response to demand. If the debtor put-off payment discussion, we coded this as a *Deferral*, and where a reason was given, we recorded this as well. This gave an approximation of ability to pay. In other words, the debtor wanted to pay, but was unable to do so for a variety of reasons (*e.g., seasonality/lack of work opportunities, personal issues, etc.*).

Willingness to pay was inferred by recording the number of cases where debtors refused discussion of the debt (*e.g., hanging up on the collector, becoming verbally agitated, etc.*). We coded these cases as *Confrontation.*

We coded disputes over the debt separately to see if there was an impact on the debtor's assessment of the legitimacy of the debt, as well.

As *Figure 3* indicates, **COVID has had an impact on promises to pay, though the 12% drop is less than expected**. **Disputes rose 20%, and that may be indicative of debtor's being overwhelmed by the magnitude of the situation of the debt**, or it could be for other reasons – we really cannot assess it further from this data.

One central point to note is that **COVID has impacted willingness and ability to pay**, with *confrontations* up 102% and *deferrals* up 22%.

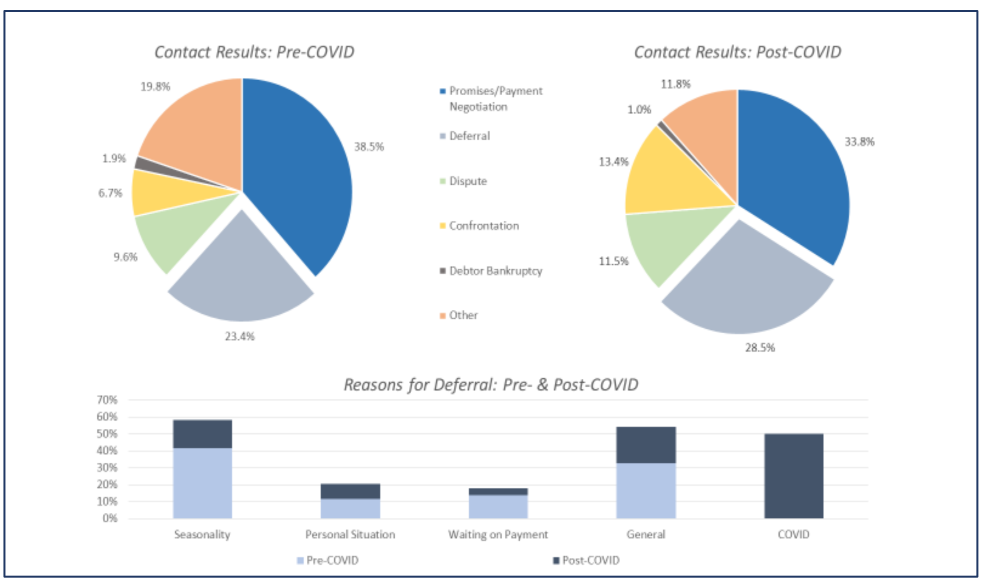
It is also interesting to note that, when reasons for deferral are assessed, though **COVID is currently accounting for 50% of deferral reasons**, deferrals have not risen by a corresponding percentage. COVID has taken the place of some of the other reasons, versus adding to them.

When this information is combined with Question 8, the opportunity from this crisis becomes more apparent.

KEY TAKEAWAYS (Question 7)

8. Promises to pay are down 12%
9. Ability & willingness to pay have both dropped
10. COVID has partially displaced other reasons for deferral of payment

Figure 3. Contact results & reasons for deferral of payment



Question 8: Why haven't promises to pay dropped as significantly as actual payments?

This final question is very important in finding the opportunity to improve collections during the aftermath of the COVID crisis. Though not direct comparisons, we can link inferences from earlier questions regarding actual payments and collectability with those from conversations with debtors.

Doing so points to the idea that, **much like the previous experience with mortgages during the last downturn, traditional industry approaches are not offering debtors the right path to repayment**.

The data seem to support the idea that the industry has been slow to adapt to these changing economic conditions.

Going back to the earlier analysis of revenue and collectability, we also examined the types of payments that we received pre- and post-COVID. **Payments-in-full are down 13%, partial payments are up by almost the same amount. Further, settlements and payment plans are roughly the same across both time periods**.

Simply put, **clients can maximize their collections by embracing upfront settlements and a broader range of payment plans**. This will be especially useful for clients serving the highest-risk business segments.

KEY TAKEAWAYS (Question 8)

11. Payment-in-Full is down 13%
12. Partial payments are up 13%
13. Settlements and payment plans are roughly the same as before COVID

OVERALL FINDINGS

Taken as a whole, the results of this whitepaper point to the need for **a more nuanced approach** to addressing the fallout from the COVID crisis to the commercial accounts receivables industry.

If we continue to use the same one-size-fits-all strategy of payment demand and offer acceptance, client's returns will not be maximized, at the very least in segments at risk for greater COVID impact. Returns will continue to be lower than before, and the return to higher recovery levels will likely be slower than the drop, due to businesses having to rebuild before repaying debt obligations.

Further, some clients feel that **continuing to place accounts in the face of the crisis alienates customers and makes recovery even less likely**. This may be one reason driving the drop in average placement balances during the crisis.

Conversely, **holding placements until the crisis has passed presents an even worse alternative**. In addition to businesses having fewer assets after the crisis than before, the legal system may be overwhelmed as creditors get in line to resolve accounts through the court system. Thus, legal timelines will lengthen, and recovery could take longer once jurisdictions come back online. Complicating this is the fact that, as businesses falter, they often have multiple creditors for their limited assets, and the longer a creditor waits to pursue collection, the further back in line they go to compete with other creditors.

Looking back at the last crisis, the mortgage servicers who responded in a more consultative manner, offering solutions that were tailored to address failures of ability and willingness to pay were the ones who weathered the storm best - the same thing could be true for commercial credit departments today.

Lessons from the Last Crisis

The lessons are clear for clients who heed them:

1. **Don't bury your head in the sand** and expect things to go back to normal once the initial COVID wave has passed.
2. Be certain that your agency partners **have the continuity of operations to respond effectively** during the crisis.
3. **Compete for wallet-share** with other creditors by continuing to place accounts.
4. Begin thinking of collections more broadly as loss mitigation. **Consider your recovery strategy** – should you lower settlement parameters, push payment plans, forbearance or other customer-centric approaches?
5. **Utilize the data to your advantage**. This involves potentially working with your collections agency to design customized approaches based on placement date.
6. With creativity and partnership, creditors and agencies can work with debtors to **find a solution**.

ABOUT THE AUTHOR

Seth Carter is the Vice President, Technology & Collection Sciences for AGA. He holds a Ph.D. & Master's in Social Psychology from the University of North Carolina at Chapel Hill. He has worked extensively in accounts receivables & mortgage servicing, designing analytical models to optimize recovery rates. In addition, he has authored multiple patents and scholarly articles integrating behavioral sciences research & statistical modelling into collections strategy.