

Strategic Customer Targeting Using Legal Collections*

Strategic Customer Targeting

Personalized service, giving every customer a level and style of service that perfectly matches their unique characteristics, has long been the goal of marketers. Three factors have made this goal elusive: one is the difficulty and cost of acquiring the necessary knowledge about each individual customer; the second is the cost of bringing the specialized resources to bear at the precise moment the customer wants service; the third is a general lack of understanding of how individual customers will respond to specific service treatments (for example, how many purchasers of L. L. Bean canoes will place orders upon receipt of unsolicited fly fishing catalogs?). In general, one could say that the goal of personalized service has not been met because of the lack of cost-effective *business models* that would justify and support highly targeted, personalized programs.

Strategic customer targeting refers to a broad, new trend in management in which innovations in technology and analytic techniques have made possible a variety of programs aimed at individual customers (see Kocjan and Sylwester, *American Banker*, 1997, attached). Many of these programs involve marketing products to new or existing customers. For example, L.L. Bean does in fact use sophisticated data analysis and modeling techniques to select who will receive specialized catalogs, and First USA uses statistical techniques to direct its cross-selling approach for credit insurance and other credit card-related financial products.

However, not all instances of strategic customer targeting involve the sales process. MBNA America, for example, uses real-time access to customer data and matching software to select a negotiation strategy for its call center operators when a customer calls to cancel an account. As another example, a number of lending institutions are beginning to apply this concept to how they manage delinquent creditors. Credit card lenders, for example, manage accounts with millions of customers at any one time. Of these millions perhaps 100,000 per month become at least 30 days overdue in their payments. This large flow of potential bad debt poses an enormous management challenge. Which of these accounts are simply sloppy payers, who pay off their debt on their own accord (and pay late fees), without expensive reminders? Which will respond to inexpensive reminders such as late notices or computer-generated voice messages? Which will

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respond favorably to a more expensive conversation, and which will only respond to a credible threat of legal action? Deciding which of these treatments to apply to a given account (and there is an infinite variety of strategies for dealing with individual overdue accounts) requires all three elements of strategic customer targeting:

sophisticated sources of detailed data on individual account holders, knowledge of the costs and feasibility of applying one of the many different treatments, and business models that identify the best choices of treatment for individual customers. We might add a fourth requirement: the institutional flexibility to design and redesign business processes to make the best possible use of these data and models.

Legal Collections

One approach to collection of bad debt is to threaten, and in some cases to carry out, legal action. This approach is generally targeted at those who have the ability to pay their debt but are not currently willing to do so. Traditionally, it has been used as the last resort, after many less costly attempts have been made to collect. It has also generally been used only on accounts with large balances, due to the significant costs of legal action.

Legal collections can involve in-house attorneys or the use of outside counsel. A number of networks of collections attorneys have been created that offer nationwide coverage and economies of scale. The legal option can also be targeted at accounts either before or after they are charged off by the lender (which usually occurs when the account is 180 or 210 days delinquent). The traditional approach is to use the legal channel only after charge-off, but there is a recent trend towards using this approach at earlier stages to prevent or mitigate charge-offs.

Any legal collections process involves three phases (see “Overview of Litigation Process,” attached). The first phase involves selecting, from all overdue accounts, those for which the legal channel is appropriate. If an account is not selected for this channel it will receive some other treatment, which we will refer to as Business as Usual (BAU). Phase two involves a number of different actions, such as sending a dunning letter or making a phone call to the account holder, that are typically done in-house. The final phase involves legal action: initiation of court proceedings and a legal judgement to garnish the wages of the debtor. At each stage, of course, some accounts may pay off their debts. If an account goes all the way through the legal process without a satisfactory resolution, the lender may sell the account to a collection agency. This effectively eliminates the account from the lender’s books, but of course it results in recovery of much less than the original amount owed.

Of course, this view of the legal collections process is highly simplified. There are literally hundreds of alternative decisions that could be made to determine how an individual account will be handled. The debtor’s responses to early treatments should, logically, have an impact on later treatments. In the face of this complexity, and lacking a systematic analytic approach, most creditor firms rely on a small subset of choices, using a small number of decision variables and simple rules of thumb to determine how to handle an individual account.

Account Screening

The first phase in legal collections is to determine which accounts will be selected for this class of treatments. All others will receive some default treatment (BAU). Typically, accounts are selected from those that are overdue 30 or more days, and that are felt to be unlikely to pay on their own in the near future, not prohibitively expensive to litigate, and likely to possess sufficient assets or income streams to garnish. The evaluation of which accounts fall into this category has traditionally been done by hunch, without any analytic support. The result has been to extend this treatment only to a small number of accounts that were clearly able yet unwilling to pay. With the advent of more analytic approaches the trend has been to apply the legal channel to a higher volume of accounts, with lower average values, and to tailor the treatment to the account.

Many different characteristics of the individual account may influence whether it is an attractive candidate for legal collection. The following is a list of some typical attributes often used in this screening process, along with a description of why they are important:

Factor	Rationale
number of days payment is late	Too soon: customer may pay on own, wasting legal filing costs and alienating customer Too late: other creditors are “first in line, first in payment”
home state of creditor	States differ in their friendliness toward creditors and borrowers, e.g., garnishing ability, ease of bankruptcy. Legal filing costs differ across states.
size of balance	Too small: legal costs swamp amount collected Too large: customer has lower ability to pay
known place of business	Indication of holding job, potential garnishment target in some states
mortgage assets	Wealth indicator, potential lien target in some states
installment loan balance	May be indicator of debt familiarity. But high level of indebtedness to others may reduce ability to collect on own debt
payment in last 30 days	Indicator of willingness to pay
pending bankruptcy	Bankruptcy filing may repudiate debt
tax lien	Asset indicator, but lien may reduce ability to garnish the asset

Some lenders have discovered that only 5-10% of all overdue accounts merit treatment through one or another type of legal channel.

Developing a sophisticated legal collections process requires formulating and testing “routing” models that can rank overdue accounts, from those most likely to respond favorably to legal treatment to those least likely. These models are predicated upon three types of data: outcome data, showing which accounts in the past have been paid off or charged off depending on the treatment given; predictor data, specifying the characteristics of individual accounts that determine how they will respond; and

economic data, including litigation and other operational costs of both the legal channel and BAU. These “routing” models typically contain a behavioral component, which predicts the probability of an account paying off or the amount expected to be paid off, a financial model, which includes the relative costs of alternative treatments, and a combined model that provides a numerical score for each account which indicates the treatment it should receive.

Modeling within a Learning Environment

Given the low level of knowledge about these issues in most lending organizations and the speed with which products and customers change, it is unrealistic to think that an effective legal collections model and business process could be created all at once. Indeed, the ability to develop tentative models quickly and to learn from them is a key element in strategic customer targeting. Rapid prototyping begins with collecting limited but easily-available data and constructing first-generation models. These models (and the related business processes) are then implemented on a small but representative group of customers. The primary purpose of this phase is not to optimize collections but rather to learn as much as possible about the adequacy of the models and the treatments used. Indeed, organizational learning is a vital part of a successful rapid prototyping approach. Successful organizations go through multiple cycles of model building, testing, learning, and revision. At each iteration, the model building can draw on a greater quantity and quality of data. The later models may bear little relation to the earlier ones as new treatments are tested and old theories are modified or discarded. This approach also allows the organization to benefit early on from improvements in the collections process itself, which always makes the ongoing process less susceptible to organizational politics.

Assignment

You have been hired by a large issuer of credit cards to design an improved legal collections process. They have provided extensive account-level data which you can use for prototyping a model (see the spreadsheet “LC Data” and the accompanying data dictionary “LC Data Dictionary” in the Course folder). Note that a limited legal collections program is already in place. Your prototype model should help answer the basic question: which types of account should we target for legal collections, and why?

In addition to a prototype model, you have been asked to design a program for implementing your prototype and for structuring organizational learning. You should be as explicit as possible about the activities that will go on in the phases of the program you recommend, how long each will be, how the model itself can be expected to evolve, how the benefits will be realized, and so on.