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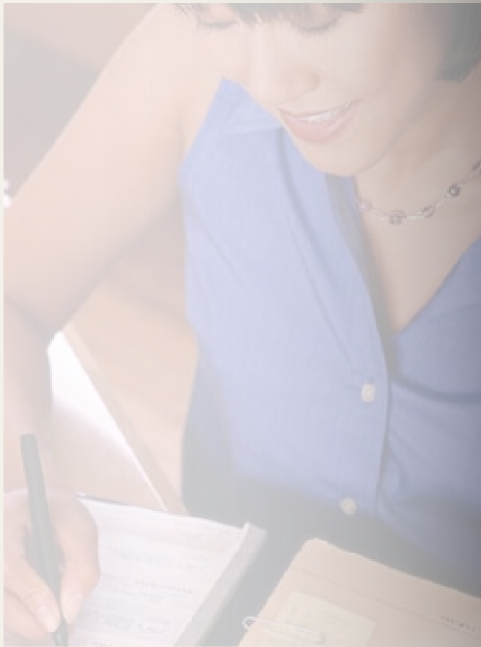
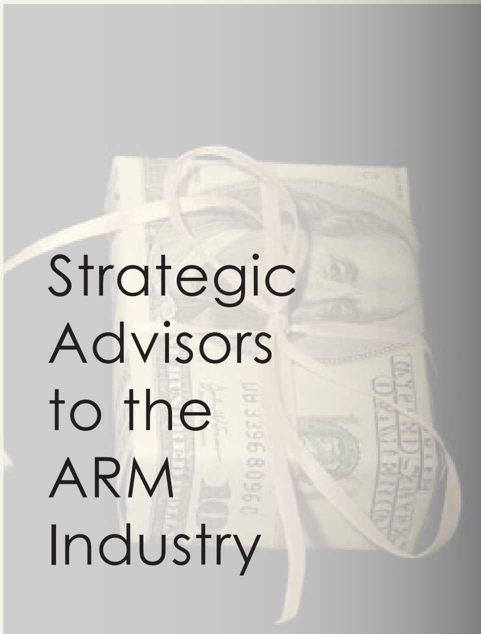
# EXECUTIVE BRIEF
# Settlements in Full: Debt Collection and the U.S. Economic Recovery





Strategic Advisors to the ARM Industry

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Kaulkin Ginsberg is the leading strategic advisor for the accounts receivable management (ARM) industry. For ARM service providers, our value-add services focus on analysis, growth, and exit strategies. For credit grantors, our focus is on optimizing receivables management strategies. Sister company insideARM.com is the worldwide leader in providing timely news and insight on the recovery of debt in all industries. The site provides creditors and service providers with news, information, and analysis on the collection of bad debt. Our daily newsletter, blogs, or executive briefs, all are within reach and free of charge.

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The U.S. consumer credit crisis has reshaped the collection and recovery industry in many ways. As this crisis ends, Settlements in Full (SIFs) comprise one of the most important and least-discussed issues for the industry in 2010. SIF policies are impacting and will continue to impact credit issuers, first party servicers, contingency collection agencies, debt buying companies, and collection law firms alike, for better or for worse.

These policies, adopted by credit issuers and implemented by their service providers, can improve short-term financial performance for some of these companies, potentially at the expense of others. In the long run, effective SIF policies also have potential to contribute uniquely to the U.S. economy as it continues to emerge from recession, while ineffective SIF policies can unintentionally stall economic growth.

This article examines these policies, what makes them effective, and what they mean to the economic recovery as a whole.

### SIFs DEFINED

When Payments in Full cannot be made by consumers for overdue debts, credit issuers set thresholds on the amount they will accept in order to close an overdue account. These Settlements in Full (SIFs) allow credit issuers to recover part of the extended credit immediately, while allowing borrowers to repay debts at a discount. SIF policies are typically targeted at consumers who have little or no ability repay their obligations in full, in hopes that a credit issuer will benefit from more repayments at a lower amount than it would from fewer repayments at a higher amount.

Credit issuers not only set different thresholds for settling an account but also set different thresholds for debtors at various stages of delinquency as well. As a result, a settlement offer to the same debtor should increase as a charged-off account ages and as recovery efforts become more challenging.

These thresholds are communicated to the credit issuer's collection agencies, so an individual collector working within a collection agency can resolve a credit card bill for some percentage of total face value. SIFs are popular with individual collectors because they make commissions easier to earn.

While this recovery strategy has always been a tool for collection and recovery professionals, it has been utilized more and more as the recession increased the difficulty of traditional recovery efforts.

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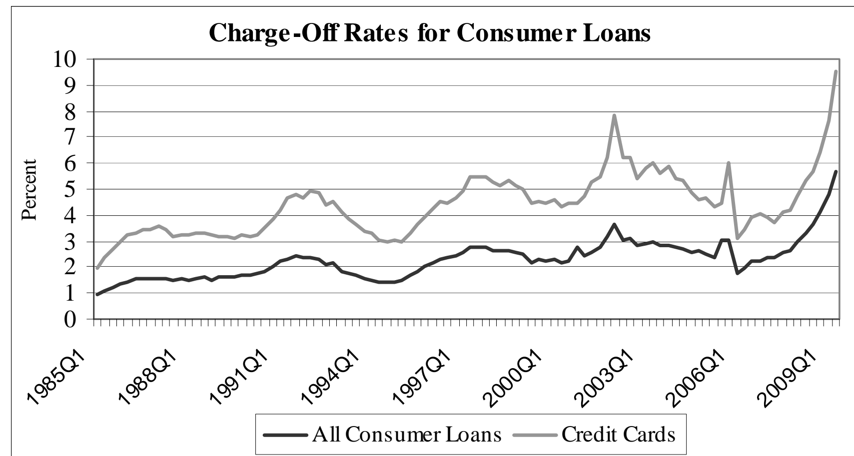
## THE NEED FOR MORE LENIENT SIF POLICIES

The credit and collections industry has been far from immune from the most significant economic downturn since the Great Depression.[1]

Credit issuers saw liquidation rates drop precipitously since the recession began in December 2007. By the end of 2009, recovery executives were reporting monthly liquidation performance down as much as 50 percent or more year-over-year. Figures such as these are remarkable given the baseline for these comparisons; the 12-month period ending in December of 2009 began when the recession was at its peak.




Flooded with placements, many contingency collection agencies have seen margins shrink throughout the recession, with falling liquidation rates and increased costs weighing on the profitability and financial stability of many (but not all) companies in this industry. Some agency owners consider them-selves fortunate to be running their companies with no growth in profits – or no profits at all – in 2009, hoping that an economic recovery will allow them to become more profitable in 2010 or beyond.

A dearth of funding for debt purchasers has also kept many buyers on the sidelines, even as prices have dropped to near historical lows. With freshly charged-off portfolios selling for as little as 5 cents on the dollar, down from 15 cents or more around 2007, the lack of visibility to better liquidation performance has kept seemingly attractive portfolios from being bought and sold.

For all of these reasons, a glut of charged-off paper is sitting in the offices of recovery executives and collection agencies throughout the country as the economy emerges from the recession. Given forecasts for high unemployment rates and weak consumer spending, credit card charge-off rates are expected to hover between 9 and 11 percent even as the economy rebounds.

Liquidation rates of post-chargeoff consumer debt most closely correlate with the unemployment rate. A recent survey of economists conducted by the *Wall Street Journal* suggests that the unemployment rate will remain well above 9 percent throughout 2010, and is not expected to fall below 6 percent until 2013. This suggests that collections and recoveries will continue to remain challenging for some time.

[1] The term "collections" typically involves pre-chargeoff paper, while the term "recoveries" generally involves post-chargeoff paper. The two terms are used interchangeably throughout this paper.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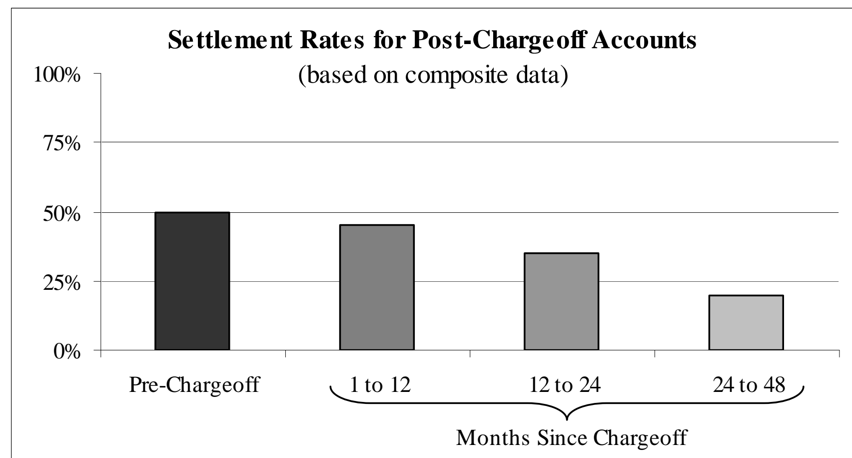
All of these forces have increased the need for better and faster liquidations, particularly among those least likely to pay their bills. SIF policies have been changing as a result.

## RECENT SIF RATES

Recovery executives and owners of prominent collection agencies throughout the country have contributed to this discussion of current market rates for SIFs. They agreed to provide this information with the expectation that their figures not be citied specifically, and that the figures not be attributed to them specifically.

The chart below describes a composite settlement policy on the part of any large credit issuing company. Settlement rates can reach 50 percent pre-chargeoff, declining over the life of the receivable to 20 percent or less when managed by a tertiary contingency agency. These figures have been revised downward at a considerable clip as the recession continued. Few credit issuers with developed recovery systems will refuse to settle accounts at early stages of delinquency, when an account is four months overdue and has yet to charge off.

Recovery executives and collection agency owners speak of settlement rates that are much lower – so low, in fact, that they seem beyond explanation. We have heard of settlement authority granted to pre-chargoff collection companies at as little as 20 percent of face value. This suggests that a $1500 flat screen purchased by a borrower in January 2009 could be paid for in May 2009 for as little as $300.




Throughout the recession, settlement rates declined to levels such as these for a variety of reasons.

First, forecasts of liquidation rate performance made by credit issuing companies have been waning as liquidation performance declined over the past two years. Whether forecasted liquidation curves decline, remain flat, or improve in 2010, upfront settlements with certain debtors remain attractive.

Second, competition has increased among credit issuers for settlement rates. Sophisticated debtors can choose to settle one credit card account, for example, with a lower settlement rate while leaving another card unpaid. As credit issuers competed for the "wallet share" of borrowers on the basis of interest rates, frequently flyer miles, and other perks in 2006, credit issuers now compete with each other on the basis of settlement rates, with payment sometimes going to the issuer willing to resolve its past-due accounts for less.

Third, the owners of many collection agencies and first party service providers have been happy to incorporate lower settlement rates into their talk-offs with debtors. Providing this incentive for borrowers to repay their accounts also improves the immediate financial performance of receivables management companies in difficult economic conditions.

For all of these reasons, Settlements in Full have become a different collection strategy for a different period of time.

## SIFs AND NET PRESENT VALUE

Like other recovery strategies, SIFs are approached by credit issuers based on the time value of money. When the net present value (NPV) of a settlement at chargeoff exceeds the present value of cash flows resulting from more of a long-term payment plan negotiated by a collection agency, for example, all credit issuers should choose to settle the account with the borrower, all other things being equal.

By definition, a settlement takes place earlier than a more protracted payment plan that could be established for a debtor. Importantly, settlements may be less expensive for an issuer, particularly if it can negotiate the settlement itself prior to chargeoff, rather than pay a contingency fee to an outside agency. A settlement is also less risky than a more protracted repayment process, as it does not require additional commitments from a debtor over time. These factors and a host of others will be incorporated into the financial models of credit issuing companies to determine whether settlements should take place, and at what rates.

NPV considerations also come into play around the timing of contingency agency placements. Take the case of a $10,000 debt that a debtor may pay at chargeoff. Settle for 75 percent, or give an agency authority to settle at 75 percent as it collects a 20 percent contingency fee? The answer is clear. The same kind of math plays out later in the recovery process. Allow the primary agency to settle at 50 percent and collect a 20 percent contingency fee, or allow a secondary agency to settle at 50 percent and collect a 35 percent contingency fee? Here again, the answer is clear. Settlements allow credit issuers to bring their cash flows forward while avoiding more complicated and more expensive collection methods that would otherwise be required.

When SIFs are attractive for credit issuers based on NPV, they may also be attractive for first party servicers or primary contingency agencies working fresher accounts. Downstream service providers, however, approach SIF policies less favorably, since offers taking place earlier in the recovery process will make later stage collections more difficult. A borrower who receives an offer to settle an account for 50 percent of face value when it is six months old will be less likely to settle more of the account when it is two years old. Collection law firms working older accounts and debt buyers that have acquired older paper generally prefer to work accounts that have previously received generous settlement offers. It goes without saying that settlement policies on the part of credit issuing companies are not equally popular.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## CRITERIA FOR EFFECTIVE SIF POLICIES

SIF policies have some place within the recovery strategies of credit issuing companies. SIF policies also have risks that credit issuers and their service providers must weigh when devising or implementing SIF programs. These policies should be:

### Applied to the right types of borrowers

SIFs are not necessary for borrowers who fail to pay their balances periodically, and whose debts charge off from time to time. In the long run, these borrowers are most likely to pay their balances in full – making them the most profitable type of customer for credit and collection purposes. Traditional recovery efforts should be directed towards these borrowers, from the day the account goes delinquent to the day it goes out of statute, without settlements being offered to encourage repayment.

SIF polices should only be directed at the borrowers who have no ability to repay their debts. For these borrowers, collection efforts will be expensive and likely unprofitable, both for the issuer and for the collection agencies seeking to recover these accounts.

Like other recovery strategies, SIF policies should be precise. As a portfolio of debt can be defined narrowly as part of the debt sale process, a portfolio of accounts can be segmented for SIF policies. For example, a group of borrowers with low credit scores, low balances, with addresses in the state of Texas could be targeted for a lower SIF threshold. SIF programs are much more likely to create the desired outcomes in this manner. At the same time, SIF policies at seemingly indefensible thresholds (e.g., 20 percent pre-chargeoff rates) are likely targeted to narrow populations such as this.

### Applied in the right way

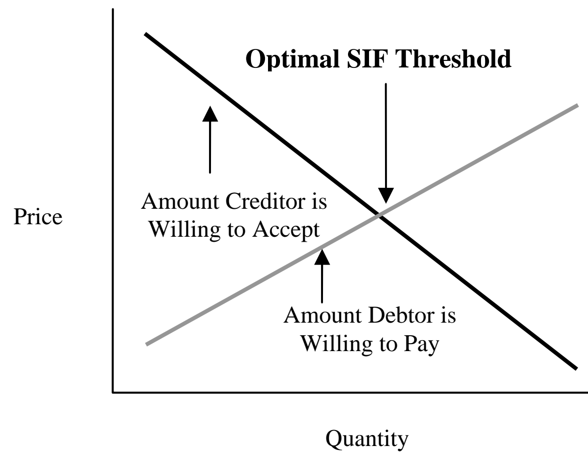
SIFs should be used as a last resort. When a credit issuer authorizes a collection agency to settle an account at a certain threshold, collectors should not even begin negotiations based on this threshold, even if it's available as a matter of policy. For liquidation rates to be maximized in a way that benefits the issuer and a collection agency, the SIF threshold should be seen as a floor, not as a starting point, and certainly not as a ceiling. Collectors who approach settlements as an easy alternative to more complicated collection efforts put SIF policies at risk, given the lower overall liquidation rates that are likely to be experienced by their clients.

### Applied at the right times

Accounts are more difficult to collect in full after they have received offers to settle in full. A primary contingency agency, for example, will have a more difficult time receiving full payment on outstanding accounts when an issuer has made SIF offers prior to chargeoff on the same amount. Lower settlement authority may have to be granted on these accounts as they age.

Decisions like these must draw on the analytics that issuers use to evaluate the comprehensive efforts of its recovery function -- to evaluate not only how a group of primary collection agencies is performing, but how its performance affects subsequent placements to a group of secondary collection agencies, etc. SIF policies should be evaluated within this context as links in the overall recovery chain.

### Applied in the right amounts




SIF thresholds should maximize cash collections, much in the same way that supply and demand should set prices for products in the broad economy. A downward sloping supply curve, the amount a credit issuer is willing to accept to settle an account, should increase in quantity as it decreases in price, to the point where it intersects the upward sloping demand curve with the reverse characteristics. In this manner, small markets are formed for debt repayment, determining the "Optimal SIF Threshold," the amount a debtor is willing to pay and the amount that an issuer is willing to accept to settle accounts in full.

Both lines will shift left and right based on different factors, such as the age of the debt, its prior treatment, the short-term cash needs of the recovery operation, etc. Much of the recent decreases in SIF rates can be explained by the need for credit issuers to receive cash more quickly (shifting the supply curve to the left), and by the inability of consumers to repay these debts (shifting the demand curve to the right). Both inputs lower optimal settlement thresholds.

At least to a certain extent, credit issuers do well to let market forces define SIF policies in this manner, within the mini-markets created by narrow segmentation policies.

## THE ECONOMIC IMPACT OF EFFECTIVE AND INEFFECTIVE SIF POLICIES

A return to robust economic growth in the U.S. will be based on improved consumer spending and on the more responsible use of consumer credit. Moreover, higher chargeoffs, higher unemployment, and lower consumer spending disproportionately involve the lower middle class – the people targeted by SIF policies. These policies present these borrowers with their most feasible option to repay their debts, and to become better borrowers in the future.

At the same time, SIF policies have the potential to encourage an undesirable behavior. Pay off your $1500 flat screen for $300 just five months after purchase – then why not settle your other balances in the same way, given the opportunity to do so in the future? If SIF policies have an unusually direct impact on the U.S. economy, is the impact positive or negative? Similarly, will lenient SIF policies created for 2010 lead consumers to require the same repayment terms later, after overall economic conditions have improved? In the long run, the credit and collection industry could very well suffer from a hangover created by ineffective and over-lenient settlement policies

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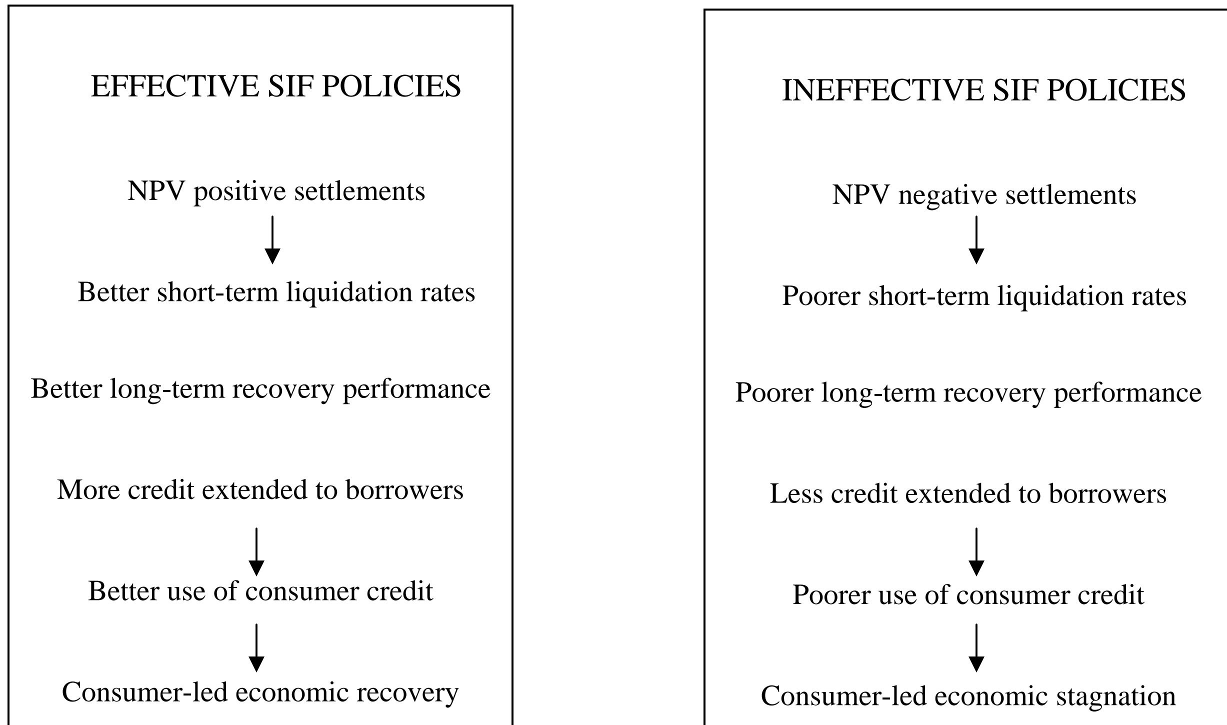
created in 2009 and 2010. SIF thresholds will clearly prove easier to decrease now than to increase in the future.

This paper suggests that *effective* SIF policies have the potential to create indirect economic benefits that can contribute to a stronger and faster economic recovery. At the same time, *ineffective* SIF policies have the potential to create negative short-term and long-term consequences, ultimately impeding the U.S. economic recovery.




There are debatable assumptions in these flow charts, based on realities in the recovery operations of credit issuing companies and in the broader consumer credit markets. This argument may not be direct as the arrows here suggest.

Still, SIF policies do have a direct financial impact on credit issuers and collection companies, as well as a broader impact on the consumers from whom these companies are collecting – for better or for worse. As in other aspects of recovery strategy, policies must be devised, tested, measured, challenged, and evaluated in attempts at improving performance.

## RECOVERIES IN THE ECONOMIC RECOVERY

It is often said that the purpose of collections is to make the credit granting process more efficient, so losses can be minimized and so credit can be less expensive for deserving borrowers. Collections and recoveries also have another obvious benefit to credit issuing companies: to bring lost cash back onto balance sheets. These definitions, however, could be applied equally in 1990, 2000, or 2010. They do not speak to the realities of the consumer credit markets today.

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Effective Settlement in Full policies allow credit issuers to expedite the overall economic recovery by improving the borrowing capacity of consumers on whom the economic recovery rests. It was, after all, dysfunction in the credit markets that caused much of the recession in the first place. Effective SIF policies – ones that are applied to the right type of borrowers, applied in the right way, applied at the right times, and applied in the right amounts – can help restore some function to the consumer credit markets, and allow the credit, collection, and recovery industries to participate meaningfully in the recovery of the U.S. economy in turn.

### A Final Word

This executive brief is designed to give you intelligence on Settlements In Full policies, what makes them effective, and what they mean to the economic recovery as a whole. It not intended to be a substitute for legal or advisory consulting services. For more information about Kaulkin Ginsberg's advisory services to credit issuers and accounts receivable management companies, please feel free to contact:

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