# FINDING THE GOOD IN BAD DEBT

## BEST PRACTICES FOR TELECOM AND CABLE OPERATORS

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Bad debt management is a key driver of financial performance for telecom and cable operators. But it also presents a major challenge, with the risk and cost of nonpayment needing to be balanced against opportunity costs. Bad debt management techniques have a far-reaching influence. They impact much more than the control of nonrecoverable income and fraud, and should be an integral part of optimizing customer acquisition, development, and retention. If that happens, even relatively advanced operators can boost their earnings by one or two percentage points, our research shows.

Bad debt is costly for telecom and cable operators. Nonrecovered subscriber acquisition costs and nonrecoverable commissions can quickly add up, making it essential both to control the level of risk and to have an efficient recovery process in place. Fraud – when customers do not intend to pay their bills and will never become valuable – is particularly expensive, and requires tight control. In total, write-offs from bad debt and fraud can amount to one to two percent of revenue.

But for most operators, the opportunity costs of managing bad debt are even greater than the direct costs. Disconnecting potentially reliable existing clients or rejecting valuable prospective clients means foregoing future profits. Only a minority of payment incidents are high cost or fraud-related, with a high proportion of bad debt resulting from long-established and previously reliable customers, usually with relatively minor amounts at stake.

In most cases, losing these customers will mean a significant loss of future revenue. With as much as 25 percent of the churn in existing customers due to bad debt, the opportunity is therefore substantial when compared with the relatively low cost of outstanding payments. (See Exhibit 1.) Some operators decline to provide service to 40 percent of their new customers because of concerns about their debt, even though at least half of these customers would turn out to be valuable. So there is an opportunity to add significant value by adopting bad debt management practices that avoid disconnecting good customers or rejecting good prospective customers.

Of course, it's only helpful knowing that it's worth hanging onto half of your customers with payment problems if you can identify *which* half: better predictive modeling is therefore vital. A strong focus on value and bottom-line impact is also essential – such a shift away from a classical

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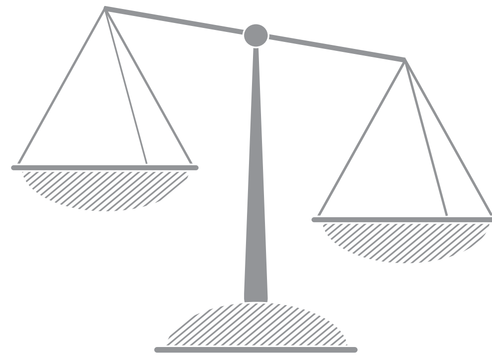
### EXHIBIT 1: AN ILLUSTRATION OF LOW IMPACT OF DIRECT COST VS. HIGH OPPORTUNITY COST

*Marginal cost on usage*

**15% to 25%**



*Collection percentage of bad debt*

**40%**

*Typical "written down" cost due to bad debt*

**0.5**

*months average revenue per user*

*Cost to acquire*

**~6**

*months average revenue per user*

*The cost of outstanding debt (being mainly interconnected costs with high gross margin), on average, typically needs just 0.5 months average revenue per user to pay back. Many customers who become bad payers were previously good paying customers...*

*...When we consider that even among those bad payers reaching disconnection stage, 40% pay up, the cost is low relative to the risk of losing the customer and trying to acquire a new one – that typically costs six months of average revenue per user!*

**Source:** Oliver Wyman analysis
**Note:** Illustrative, not all factors are included

cost control approach can deliver more profit while maintaining or even improving bad debt levels. Best-in-class bad debt management also needs to use a very broad range of tailored customer approaches.

A lot can be learned from other industries, where managing credit risk is a matter of life and death for the business. Principles and techniques from retail financial services can be particularly valuable. But it's also important to keep in mind that telecom and cable operators have fundamentally different economics. Retail credit is a low gross-margin business, with relatively low opportunity costs and a high impact for direct costs. Conversely, telecom and cable are high gross-margin businesses, with much higher relative opportunity costs. Adaptation of best practices is therefore required to fit the business model.

Overall, best-in-class bad debt management means moving away from bad debt *minimization* to bad debt *value management.* The rest of this article explores in greater detail the challenges and opportunities involved.

## ACCESS TO SERVICE

When considering signing up new customers, operators need to decide which ones to accept, and which are too risky. Most operators have mastered core risk screening and prediction techniques. They distinguish fraud from bad debt using orthogonal scores, segment

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customers by channel, product, or handset, and combine data from multiple external agencies and internal databases to differentiate risk levels as effectively as possible. When the models and automated processes are deemed insufficient, they know when to defer to a human decision. Careful testing is also carried out through regular "champion versus challenger" treatment paths.

25%
The percentage of churn in existing telecom and cable operators' customers due to bad debt

But beyond this, differences emerge between the best operators and the rest. Many operators rely upon risk-based cutoffs set arbitrarily, based on the outcome of discussions between marketing, sales, and finance – with essentially opposing objectives. But the best operators explicitly take a value perspective to acceptance, with all parties aligned in aiming to deliver the greatest overall value for the business. They account for risk in the form of fraud and nonpayment. But they also consider the likely future value of a customer, based on all of the information captured at the point of screening, such as their price plan, handset selected, and demographic.

By adopting such a view, decisions can be reached that create more value for the business. In our experience, around 30 percent of applicants are accepted when they would previously have been declined, or vice versa, resulting in significant benefits to the bottom line.

Being able to quickly offer carefully tailored products can capture value from customers who would otherwise be declined as probable bad payers. Specifically designed products such as a basic phone and lower-risk price plans can be used for this purpose along with variable deposits and dynamic credit limits once a customer has signed up.

New rewards structures also help. Commissions and incentives across marketing, finance, and sales channels need to reflect the true value of acquiring a customer, and this generally means adopting structures that combine new value-based target metrics, clawbacks, and residual/value-based elements. New soft and hard organizational structures that steer leads from finance, marketing, and sales are also typically required.

Strong analytical capabilities are equally important. Decisions need to be supported by predictive modeling to determine risks and expected value, including the prediction of other elements of behavior, such as voluntary survival and spend. By building a dynamic value and return-on-investment model allowing real-time point-of-sales decisions, for example, an operator can ensure that the decision to accept a customer is largely net-present-value based, while including some elements of risk that face the market.

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# LIFETIME COLLECTION

Once a customer is on board, the challenge for the operators is then to maximize the customer's value while controlling the potential cost at risk. Cutting customers off represents a major part of most operators' churn. Many operators are sensitive to valuable customers and continually reevaluate customers' risk levels with the latest internal and external information, to determine the best approach to collection.

While an approach focused strongly on recovery will encourage a proportion of customers to pay up, it will also drive many away unnecessarily, leading to lost profit potential. It would often take less than a month for many of the subscribers disconnected to pay back the costs of the debts they have incurred. So there is a relatively big potential upside to selectively saving and getting the customers spending again, with limited downside risk.

The best operators understand this, and actively manage the true value at risk and real loss potential from continued actions. They adopt a segmented approach, looking beyond write-off reduction. Their mindset becomes: "How do we maximize value capture by keeping customers spending for longer, rather than simply limiting bad debt, or recording a high collection rate?" They then treat customers differently based on value and need. Specific offers are developed to be used in each segment depending on the reason for bad debt and complementing traditional recovery. For example, operators may offer payment in installments, waive part of the debt, or switch the customer to a low-risk product.

## EXHIBIT 2: CRITICAL COMPONENTS TO MAXIMIZING RETURNS FROM BAD DEBT

THE VALUE DELIVERED THROUGH THE CREDIT RISK MANAGEMENT FUNCTION

**Analytical capability**

The ability to apply best-in-class techniques, methodologies, models, and tools to predict expected customer behavior and to assess the impact of decisions on economics.

**Strong value focus across the business**

Understanding the value of a customer's business allows trade-offs against cost and investment, translating credit risk decisions into bottom line profitability.

**Customized approach for each individual customer**

Finding the best way to address customer-specific issues and situations by using innovative products and solutions will ensure the capture of customers with a good return on investment and controlled risk.

**Organizational alignment**

Effective organizations are well-aligned and supported by objectives, incentives, and steering, that force decision making to drive profit. This is perhaps the hardest challenge to overcome.

**Source:** Oliver Wyman

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Of course, it's hard to know in advance exactly which approach will work with each customer. So each activity's impact on lifetime spend and the recovered amount is quantified and modeled, allowing a "test and learn" approach to in-life debt collection. Decisions are supported by lessons drawn from the tests and econometric analysis, which is constantly refreshed to keep track of any learned behaviors such as bluffing. Risk and expected value can then be rescored during the life of the customer relationship based on all available information.

## DEBT RECOVERY

When all else fails, operators need to maximize the amount they recover, at minimum cost and risk to the brand. Moving beyond the softer, more intensive strategies, the focus shifts from maintaining the customer relationship to recovering debts efficiently.

At this stage, a multiagency approach, combining internal and external agencies, is standard practice among telecom and cable operators. Agencies are carefully selected, then encouraged to compete. There is usually an internal agency, both to participate in the competitive process, and to deal with "easy pickings." Strong two-way information flow is established so that the operator knows which treatments are used with each customer, and so that each agency knows more about who they are dealing with.

But the best-practice operators go a step further than this. Debts are assigned based on their best chance to recover in addition to considerations of competition and fulfillment of other quality of service key performance indicators. At the same time, predictive models are used to understand which customer segments are best handled by which agency. The agencies' incentives are set to maximize recovered value, so that they treat all or at least most of the debt. In case of failed attempts, agencies are also incentivized to return debt early to maximize the speed of future stages and hence the recovered amounts. Finally, reconnection is also rewarded in some cases, since it can form a low-cost acquisition channel.

# CONCLUSION

Bad debt management must be treated as an integrated commercial function because it influences many aspects of value capture, from acquisition volume and quality, to churn and spend. Cross-industry best practices, from financial services especially, provide the base from which the best operators can create more value. However, these best practices need to be adapted to account for telecom and cable economics.

To make advances requires significant analytical capability, a strong focus on value across the business, a customized approach for each individual customer, and organization alignment. If this is achieved, operators can significantly improve their earnings and steps can be taken quickly that pay for themselves many times over.

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