Risk-Based Collections: Using Credit Information in the Collections Process

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Caliber Services

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"…Collection software is not simply a tool, among possibly many others, to help collectors do better. Rather, collection software provides an entirely new approach to collecting a portfolio of trade receivables within a unified process. While some of the collector's tasks remain the same or similar, the process of collections is fundamentally changed when collection software is implemented. To those familiar with change theory, collection software isn't an incremental improvement, but instead a discontinuous change with the potential to lift performance to a much higher plateau..."

Paystream Advisors, "Receivables and Collections Management Release 2.0: Emerging Solutions and Increasing Automation", 2007.

EXECUTIVE OVERVIEW

The following white paper explains how Oracle E-Business Suite can enable best practices for collections management using customer credit risk data.

INTRODUCTION

Until relatively recently, Enterprise Resource Planning (ERP) software predominantly existed to manage core business processes where efficiencies were gained by standardization and decisions were easily made based on existing system data. Now with pressures due to globalization, the diversity of processes required to manage a business, and the need to make rapid decisions in all areas of the enterprise, additional software solutions have become available to cater to many of the processes traditionally unavailable in ERP systems. With the maturity of core processes within ERP, vendors and deploying organizations have started to focus on more complex processes, leveraging new hardware and middleware technologies as well as data residing inside and outside of the corporate database.

Credit and collections processes, traditionally handled manually or with the use of products bolted on to ERP applications, are now integral to an ERP solution and the underlying data. This allows credit and collections departments to more effectively manage risk throughout the customer lifecycle, using the full range of available data with the result of attaining best practices including risk-based collections. The following article outlines how Oracle E-Business Suite can enable collections best practices using customer credit risk information.

LOOKING BACK AND MOVING FORWARD

In the past ERP systems relied upon increases in efficiency of standard processes to realize cost savings. These included manufacturing, purchasing, order management and accounting processes. More recently, improved technology has enabled more complex processes to be managed in the areas of demand planning and scheduling, balanced scorecards, business analytics, and more importantly to this audience, collections management, credit risk, and deductions processes.

Whereas ERPs have been based upon core transactions flowing through the system, the latest extensions to ERP systems use transactions created from these transactions. In the case of Oracle's E-Business Suite Credit-to-Cash solution, deploying organizations can now perform credit reviews based upon customer data, identify delinquencies based upon invoice information, and manage deductions derived from payment information. All of these new transactions are also influenced by the other processes. For example, a delinquency is identified from an invoice, but it could also be influenced by the risk classification of the customer derived from the credit review. So the invoice of a high credit risk customer could be identified as delinquent sooner and managed differently than a low risk customer's invoice.

ORACLE E-BUSINESS SUITE AND THE CREDIT-TO-CASH PROCESS

Oracle' EBS Financials products that create transactions each have the ability to automate parts of the Credit-to-Cash process. Specifically:

- Oracle Credit Management™ compiles data designated by the business to classify customers into risk categories. Classification uses configurable scoring models composed of various data points, both internal and external. The classification is also used within the application to process and automate credit decisions including periodic credit reviews, order credit checking, credit limit management, and sales prospect pre-screening
- Oracle Advanced Collections™ determines and manages the collections process, utilizing configurable collections scoring models to determine most effective collections strategies for customers based upon data in the database. Collections strategies are likewise configurable and are driven directly by the collections scores.
- Oracle Trade Management™ includes a deductions management module integrated seamlessly with Oracle Receivables™ cash application module to automate the routing of deductions to the correct resources for timely closeouts.

But, to look at the capabilities of each of these modules separately is a narrow view. The ability to use these applications together enables a greater gain than to use them individually. The next section will give an example of how to use this new functionality in harmony.

PART TWO – RISK-BASED COLLECTIONS MANAGEMENT

The effective use of and sharing of data and system mechanisms is the basis for risk-based collections management. The ability to enable risk-based collections depends on access to many different data elements and mechanisms to generate scoring of those elements. Examples of data elements and mechanisms are:

- Internal data elements – transactional and customer data to calculate delinquencies, determine the business value of customers to the deploying organization, and for credit reviews
- External data elements – third party credit and financial data providers and industry data to enable objective credit reviews and to enrich internal customer data
- Configurable credit and collections scoring models to create delinquencies from AR transactions, create risk classifications from credit reviews, factor in dispute and deduction activity, and generate business value scoring of customers for collections strategies
- The means to create customer segments, subsets of the entire customer database, for both scoring and strategy management for unique groups of customers. Customer groups may be based on any number of factors, include regional location, business unit, industry, credit risk, etc.
- Configurable collections strategies to manage those customer subsets

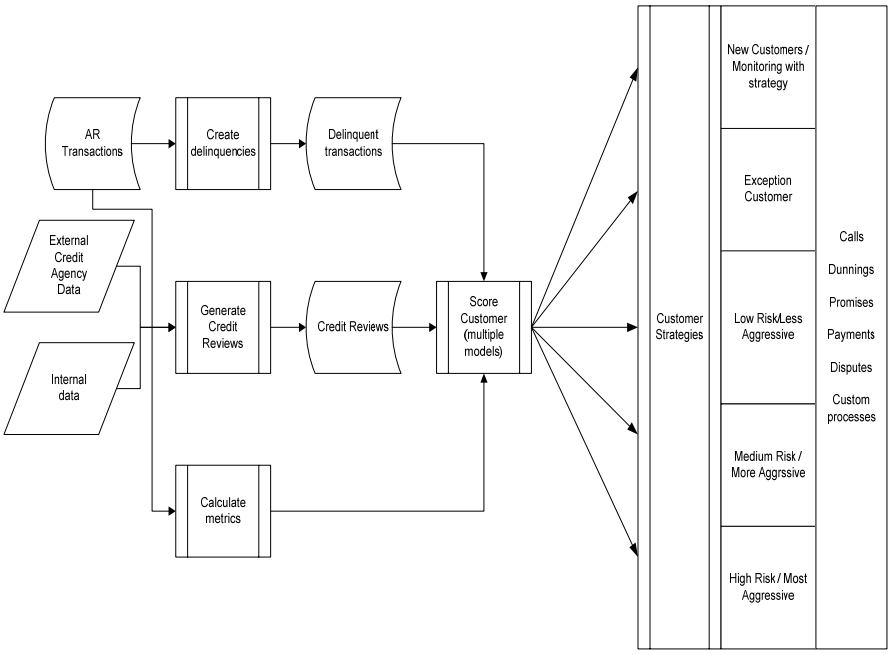

Figure 1: Risk Based Collections Model

Consider the following collections management model using the elements discussed in the previous section.

Customer Risk Classification

Initiating the process of risk-based collections begins with determination of credit classification of the customer when a credit application is received, or when a periodic review is completed. A decision needs to be made based upon the data compiled during the process to set correct credit limits and the risk classification based upon corporate credit policy.

The decision could be automated and based on a scoring model, and incorporate data elements from external credit agencies, e.g., D&B, Global Credit Services, Experian, etc, trade and bank references as well as information received from the customer such as financial statements.

A couple of points should be noted.

- New Customers: If a customer is new, it may be better to segregate and track data building up in the system even though an initial risk classification has been assigned. For instance, conduct automated credit reviews monthly to monitor the customer risk. After 3 months, slot the customer into the correct risk bucket for collections. Alternatively, tracking payment and deductions performance and credit limit usage (how often the customer exceeds credit limit) could be used to trigger changes in the customer's credit policy application.
- Automating credit policy with existing customers: If a credit review system is being instituted with an existing customer base, customers should be classified with the credit review process using the data points above as well as any other internal data, e.g., Aging, Weighted Average Days Paid (WADP), Day Sales Outstanding (DSO), etc. deemed valuable.

Classification of Customers into Segments

Once the risk classification has been created for the customer, customers can be grouped within risk classes so that each class uses different scoring models on the invoices to create delinquencies. Customers can be treated differently if a delinquency is based upon transaction data and is not the invoices themselves. A delinquency in Oracle exists as a unique entity based on specified invoice criteria, not the status of an invoice. For example, low risk customers can have a greater grace period on terms than higher risk customers, and can be segmented accordingly before a delinquency is created. Alternatively, a standard single model across risk classifications can be used based on the terms of the customer (and any other factors) to decide delinquencies.

Scoring Customers for Collections Strategies

Once the customer segments and delinquencies have been created, customer scoring takes place to decide how to deal with those customers when collecting overdue transactions. Oracle Advanced Collections allows different scoring models to be used for different customers segments. In this risk-based collections example, customer segments are based on the risk classification and the delinquency data that has been compiled so far. This allows for multiple scoring models for each credit classification. The score result determines which collections strategy to apply to each customer.

A benefit of using credit information as part of your collections strategy determination is realized where credit classifications overlap. For example, if you had 2 or more strategies within each risk classification, the low end of high risk could be similar to the high end of medium risk. Both customers could be treated the same, but an additional measure could be made of the trend of the customer as they are either moving down from high to medium or moving up from medium to high.

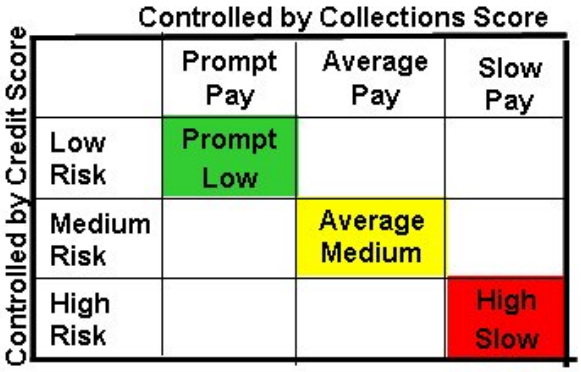

FIgure 2: Credit and Collections Scoring

Other uses of segmentation and data to score customers for strategies include segregating customers by industry. A portfolio of customers could be built using SIC identifiers. Based on credit agencies' data about customers as well as internal data, one industry may indicate an increase in risk. This could be due to DSO, WADP or increases in overdue invoices for a few customers in the industry. Or it may be for the entire industry. Based on this measurement which has been incorporated into the collections scoring model, that group of customers may have different collections strategies applied regardless of risk classification of the customer.

Of course, customers may be segmented on factors other than credit classification. An example has been noted above with new customers – if they are high risk (which is likely when there is no internal data), you may want to collect aggressively until they establish a payment behavior. A further example is exception customers.

For instance, large retailers may need to be managed differently than smaller retailers due to volume, terms, or discounts

Configuring Collections Strategies

Collections strategies themselves need to be defined for each segment. Strategies can include outbound collections calls, dunning or reminder letters via email, fax and mail, account reviews, and personal customer site visits. Combinations of calls, reviews, various levels of dunning letters, and visits enable effective collecting. Frequency and timing of calls and reviews, levels and frequency of dunning letters, and visits can be determined for each risk classification and subsection of classification. Each strategy (the unique combination of frequency and content) is associated to a customer score range.

PART THREE – CUSTOMER CASE STUDY

A privately held US-based manufacturer running Oracle's Supply Chain Management software was using a 3rd party application for its collections process. However a more comprehensive credit and collections system was desired and, following an evaluation of available solutions, the decision was made to implement Oracle Financials, including Oracle Credit Management and Oracle Advanced Collections as part of a new Order to Cash project. Additionally, Oracle Trade Management was selected to support the corporate trade promotion programs.

The credit management and collections modules were implemented in parallel, with the data points used in Oracle Credit Management's credit scoring models also being used as part of the customer collections scoring for Oracle Advanced Collections. Oracle Trade Management was implemented in a following phase but, once installed, trade deduction data was available in the Order to Cash system.

Following installation in a pre-production system, intensive testing on the planned scoring models and collections strategies was done using Excel templates to simulate the strategies and the various weights on the credit and collections scoring variables used in those strategies. The collections scoring models included a number of data points including the customer credit risk score. The results of each simulation were compared to validated customer data to ensure that the credit-to-collections scoring and subsequent collections strategy execution worked properly. By running a number of business and customer scenarios through the templates first, the customer was able to execute accurate strategies once they went live in Oracle

The project was completed successfully and the new system enabled the company to identify and manage delinquent customers based not only on the size of the delinquent balance, but also the credit risk of the customer, ensuring higher-risk customers were being collected with higher priority. Additionally, when a customer's credit risk changed, their collections score and associated collections strategy changed as well. The collections organization was able to quickly identify customers moving into higher at-risk levels and work more actively with them to resolve their overdue payments. The implementation outcome reduced DSO and enabled better control of bad debt and credit exposure.

PART FOUR - OTHER CONSIDERATIONS

Best of Breed vs. Single Vendor

The advent of new technology both in software and hardware paired with a decrease in the cost of hardware has enabled the extension of ERP processes to business areas that have been traditionally manual or handled by interfaces with external applications. This calls into question the concept of best of breed applications (i.e., pick the best application for each area of the business, and integrate) versus a single vendor solution.

The advantages of single vendor revolve around immediate availability to all modules of data as business events occur. This provides you with better and timelier access to information on payments, cash applications, invoices, orders and credit checks as well as more accurate analytic reports and real-time notifications. From a business aspect, especially where financial transactions occur across the enterprise, this is a big plus.

If the single vendor does not include best practices in their software solution, best of breed may have the advantage in specific business areas (but not likely across the enterprise), and dependence on a single vendor is no longer an issue. However, integrating best of breed solutions is unlikely to match up to single vendor packages in terms of near real-time availability of data even with EAI (Enterprise Application Integration)

ERP systems now offer the ability to incorporate more complex processes into standard applications with the ability to easily build in best practices. Credit scoring is key to a true view of the customer across the enterprise, e.g. how credit worthy is this customer? Sales organizations need to be aware that a sale is not of value if the customer is unable or unlikely to pay. Alternatively, the enterprise needs to gauge the level of bad debt; if Sales is empowered to sell to higher risk customers, they need to be aware that a higher percentage of bad debt may occur, e.g., does this customer generate sufficient revenue to mitigate the risk?. Collections organizations also need to be aware and change their strategies if credit and sales data indicate changes in general trends or specific customer behaviors, e.g., which are the customers that we need to collect from *today*?

What is missing from the enterprise--wide systems available today?

External to the business, one answer is still the complexity of human interactions and decision-making. Any information gathered by a credit manager or collections agent about a customer may be relevant to a credit decision. This could be information from industry groups, newspaper articles or any number of other sources. The future will require systems to have intelligent agents (software scanning the internet for information) continually mining the Internet for any data about customers, informing credit and collections managers, and incorporating it into scoring customers.

Internally, within systems, a view of the customer needs to continually change based upon business events. These include:

- Exceeding credit limits (taking account of payment habits and external data pointing to successful expansion of the company versus overstretching),
- Additional prospects of business from subsidiary organizations within the customer enterprise,
- Changes in payment, promise to pay, short payment, or disputing behavior,
- Changes in key metrics used by the enterprise,
- Changes in economic trends in customer industries,
- Marketing promotion activity with the customer and resulting new business,
- Increased or decreased sales for which the system should take into account why these changes take place (i.e. are they driven by the company, or the customer)
- Service issues that may indicate changes in customers' satisfaction with provided goods and services, and associated changes in their payment behavior.

CONCLUSION

The need for credit managers to assess customer risk and collections managers to track key customer and financial metrics is a critical aspect of business today. But how risk and customer behavior is tracked and measured has changed. The level of functional sophistication in software solutions is now enabling more complex processes and better use of available data to be built within ERP systems and the business applications they run.

It should be noted that the example models and all functionality discussed, other than future requirements, are available and have been implemented by companies using Oracle® E-Business Suite release 11i.9 and above.

About the Author:

Robin Walker is the managing partner at Caliber Application Services, LLC. He worked for BearingPoint (formerly KPMG Consulting) and Cap Gemini on large scale multinational ERP implementations in the area of Financials applications, and has been working with Oracle in development of modules within the credit to cash process. Prior to consulting, Robin had a variety of jobs in accounting and finance. Robin has qualifications in business, accounting and computing earned in the UK, an MBA from Drexel University, and is a member of the Beta Gamma Sigma AACSB Honor Society. His areas of interest are the credit to cash process and trade promotions management.

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