BAD DEBT VALUE MANAGEMENT
FROM BAD DEBT TO VALUE CREATION
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 non-payment needing to be balanced against the opportunity costs. Bad debt management techniques have a far reaching influence, going well beyond control of non-recoverable income and fraud, and should be an integral part of optimizing customer acquisition, development and retention. With some businesses now upgrading their capabilities on bad debt management by adapting best practices from other industries, our experience suggests that even relatively advanced operators are able to unlock 1-2 points of EBITDA in this way.

Bad debt is costly for telecom and cable operators. Non-recovered SAC or ICX costs and non-recoverable 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. Overall, write-offs from bad debt and fraud can amount to 1-2% 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 accounted for by long-established and previously reliable customers, usually with relatively low amounts at stake. In most cases, losing these customers will mean a significant loss of future revenue: with as much as 25% 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). At the same time, some operators decline as many as 40% of new customer acquisitions, even though at least half of these would turn out to be valuable customers.

So there is significant value in bad debt management practices which 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 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. While technical requirements to achieve all this are a challenge, many operators have the infrastructure in place to overcome them … effective organizational alignment on the other hand is a must and is the most critical barrier to overcome.

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 of 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 stakes are high: one major European operator recently carried out a 9-month overhaul of its bad debt management practices to deliver a sustained EBITDA improvement of 2 percentage points, while at the same time building capabilities that would deliver additional gains over the longer term. The rest of this article explores the challenges and opportunities involved in more detail.
**EXHIBIT 1: AN ILLUSTRATION OF LOW IMPACT OF DIRECT COST VS. HIGH OPPORTUNITY COST**

<table>
<thead>
<tr>
<th>Marginal cost on usage</th>
<th>Collection percentage of bad debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>15% to 25%</td>
<td>40%</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Typical “written down” cost due to bad debt</th>
<th>Cost to acquire</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.5 ARPU month</td>
<td>~6 ARPU month</td>
</tr>
</tbody>
</table>

The cost of outstanding debt (being mainly interconnect costs with high gross margin), on average, typically needs just 0.5 months ARPU to payback. Many customers becoming bad payers were previously good paying customers …

... When we consider that even among those bad payers reaching disconnection, 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 6 months of ARPU!

*Note: Illustrative, not all factors are included*

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**MANAGING THE BAD DEBT LIFECYCLE**

To understand where the biggest opportunities lie, it's helpful to consider each of the three fundamental stages of bad debt management in turn:

- Screening for **access to service**
- In **life collection** of unpaid bills of customers
- More intensive **debt recovery**, typically post (at least partial) disconnect

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**EXHIBIT 2: THE DIFFERENT LIFE CYCLE PHASES OF BAD DEBT MANAGEMENT, OBJECTIVES**

<table>
<thead>
<tr>
<th>ACCESS</th>
<th>IN LIFE</th>
<th>RECOVERY</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Maximize client value acquisition while minimizing risk</td>
<td>• Maximize in life client value</td>
<td>• Maximize amounts recovered at a minimum cost (recovery optimization)</td>
</tr>
<tr>
<td>• Filter access of clients that will become bad payers with negative marginal value, however avoiding screening of positive value clients</td>
<td>• Whilst minimizing potential cost at risk and existing receivables</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Define products for risky client migration</td>
<td></td>
</tr>
</tbody>
</table>
ACCESS TO SERVICE

Clearly, when considering signing up new customers, operators need to decide which to accept, and which are too high risk. Most operators have mastered core risk screening and prediction techniques: they distinguish fraud from bad debt using orthogonal scores; segment 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 vs. challenger’ treatment paths.

But beyond this, differences emerge between the best operators and the rest. Many operators rely upon risk-based cut offs which have been set arbitrarily based on the outcome of discussions between marketing, sales and finance – with essentially opposing objectives. In contrast, the best operators explicitly take a value perspective to acceptance, with all parties aligned in aiming to deliver most overall value for the business. They account for risk in the form of fraud and non-payment, but also consider the likely future value of a customer, based on all the information captured at the point of screening (such as price plan, handset selected, demographic ...). By adopting such a view, decisions can be made to create more value for the business.

A carefully-tailored product range provides scope to offer value-positive alternatives to customers who would otherwise be declined as probable bad payers. Being able to quickly offer the right product can lift both acceptance rate and the value captured: specifically-designed products can be used for this purpose (basic phone, SIM only, lower risk price plans – sometimes bespoke, etc.), along with variable deposits, and dynamic credit limits once the customer has signed up.

Implementing a ‘value-focused’ approach to customer acquisition usually means overhauling the business’s rewards structure. Commissions and incentives across marketing, finance, and the 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 are typically also required – for example steering integrating leads from finance, marketing and sales.

Strong analytical capabilities are equally important. Decisions need to be supported with powerful predictive modelling 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 ROI model allowing real-time POS decisions, the operator can ensure that the decision to accept is largely NPV based, while including some elements of risk to face the market.

In our experience, adopting a value-based approach to managing access to service usually means significant changes in which customers are accepted or rejected: around 30% of applicants are reassigned, i.e. accepted when they would previously have been declined, or vice versa. This brings significant benefits to the bottom line.

IN LIFE COLLECTION

Once a customer is on board, the challenge for the operators is then to maximize their value while controlling the potential cost at risk. Involuntary churn – i.e. cutting customers off – represents a huge 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. In a low-growth environment, Finance is under pressure to limit the business’s exposure to increasing levels of bad debts and write-offs. While an approach focussed strongly on recovery will encourage a proportion of customers to pay up, many are driven away unnecessarily, leading to lost profit potential. Many of the subscribers disconnected as bad debt have been profitable paying customers for a long time: it would often take less than a month for them to pay back the costs of the debts they have incurred, so a relatively big upside is available from 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 (cost). In-life bad debt management means distinguishing the ability to recover past balance from an assessment of the future value expectancy, which should then drive the decision to keep a customer active. Looking beyond risk level to understand the customer allows recognition of important differences underlying non-payment. For example some customers may be upset with their operator, have suffered a one-time usage incident they wish to negotiate or be too disorganized to pay on time.

The best operators therefore 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. Different approaches are applied for each segment (harder/softer approaches, different time scales, contact techniques, hard/soft service barring). Specific offers are developed to be used in each segment depending on reason for bad debt, complementing traditional recovery – examples might be payment in instalments, waiving part of the debt, or switching the customer to a low risk product.

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 recovered amount is quantified and modeled, allowing a ‘test and learn’ approach to in-life debt collection. Decisions are supported by learnings from the tests and econometric analysis, which is constantly refreshed to keep track of any learned behaviors (e.g. bluffing). Risk and expected value can then be re-scored during the life of the customer relationship based on all available information.

To manage these different recovery strategies by segment, a segmented queuing system is used. Advanced predictive behavioral models, tied to marketing understanding, are built to classify customers based on past activity. The overall objective is to maximize the value created by keeping the customer for longer and spending more, and also factoring in the total amount (margin adjusted) that can be recovered in the event the customer can’t be retained. These best-in-class collections techniques increase collected revenues and increase customer lifetime value contribution by reducing churn.

EXHIBIT 3: VALUE BASED COLLECTION

<table>
<thead>
<tr>
<th>DATA INPUTS</th>
<th>VALUE STEERING DASHBOARDS</th>
<th>PROFIT/P&amp;L NET OBJECTIVES</th>
<th>PROFIT INCENTIVES / PERFORMANCE MANAGEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer attributes</td>
<td>Pre-incident behavior</td>
<td>Human judgement</td>
<td>PROFIT BASED DECISION MAKING</td>
</tr>
<tr>
<td>External data refresh</td>
<td>Historical behavior</td>
<td></td>
<td>Churn control</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Lifetime value</td>
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<td></td>
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<td></td>
<td>Future ROI</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Recovery Cost at risk</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Write off</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Retention/Recovery related reward</td>
</tr>
</tbody>
</table>

OPTIMIZE TREATMENTS BY SEGMENT

- Risk/recovery prob.
- Marketing approach
- Expected value

APPLY TREATMENTS

- Primary routes
- Test groups

ALTERNATIVE TREATMENTS AND PRODUCTS

- Retention mechanisms
- Credit risk products and solutions
- Recovery actions
- Charges
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 multi-agency 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”. A strong two-way information flow is set up 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. While the debt sale market is commonly used as the last call, taking care to avoid harming the operators’ brand.

But the best practice operators go a step further than this. Debts are assigned based on the best chance to recover in addition to considerations of competition and fulfillment of other quality of service KPI, while predictive models are used to understand which customer segments (soft disconnects, automated messaging, etc.) are best treated by which agency. The operator also provides more input into the treatment, since some customers are more sensitive to certain approaches (legal, direct mail, phone contact, doorstep etc.). 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 incentivised 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 (albeit a low volume one).

Control over the full process, from where to assign to who and what treatment should be given, can create value by greatly enhancing recovery while controlling cost.

EXHIBIT 4: DEBT COLLECTION AGENCY ALLOCATION AND MANAGEMENT PROCESS

Disconnected accounts

Assignment according to
Balance
Behavioral score

Assignment according to best chance to recover

1st PLACEMENT
3-6 MONTHS

Operator

Early return encouraged

Redistribution of accounts among DCA

Redistribution according to best chance to recover

Predictive models

FEEDBACK AND INFORMATION

FEEDBACK AND INFORMATION

DCA 1
DCA 2
DCA 3

Standard
Best in class

1st PLACEMENT
3-6 MONTHS

2nd PLACEMENT
3-6 MONTHS

Write-off
Debt Sale

Reconnection incentivised

Disconnected accounts Write-off

Redistribution of accounts among DCA

Redistribution according to best chance to recover

Predictive models

FEEDBACK AND INFORMATION

FEEDBACK AND INFORMATION
CRITICAL COMPONENTS TO SUCCESSFULLY MANAGE BAD DEBT FOR MAXIMUM ROI

Overall, then, there are 4 critical elements that need to be mastered in order to optimize the value delivered through the credit risk management function.

**Analytical capability**  
Ability to apply best in class techniques, methodologies, models and tools adapted from FS/consumer credit, to predict expected customer behavior and assess the impact of decisions on economics.

**Strong value focus across the business**  
Strong business value understanding 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 of addressing customer-specific root cause issues and situations, using innovative products and solutions, to ensure the capture of customers with a good ROI and controlled risk.

**Organizational alignment**  
To “caricature” we may think of a typical organization where finance focuses on bad debt reported numbers e.g.: write-offs, bad rates, level of involuntary churn, disconnects after 30 days etc. Sales cares about sales numbers, acceptance rates, getting customers through and sees credit risk as a hurdle. Marketing focuses on P&L of the base, and follows KPI such as churn and acquisition, sales numbers and acceptance rates, level of involuntary churn. Such a structure, combined with a lack of alignment of incentives, naturally creates conflict and inefficiency. 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!

**CONCLUSION**

Bad debt management influences many aspects of value capture, from acquisition volume and quality, to churn and spend, and must be treated as an integrated commercial function. 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 careful adaptation to telecom and cable economics.

The rewards are great – 1 to 2 points of EBITDA is achievable – depending on the operator’s current approach and capabilities, and on the organization’s ability and motivation to make the advances. As a major European operator has recently shown, steps can be made quickly and pay for themselves many times over with short paybacks.

To make the advances requires significant analytical capability, a strong value focus across the business, a customized approach for each individual customer and critically organization alignment.
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