Global Practices in Responsible and Ethical Collections

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Defining ethical collections

Ethical collections can be defined as balancing three components:

What is best for the borrower?

- Boundaries on collections practices ensure that consumer rights are protected and respected
- Ethical collections practices do not mean being “soft” on collections or not trying to collect on debt

What is best for the institution?

- Successful collections efforts are critical to maintaining access to credit
- Without sufficient recoveries, institutions face higher charge-off costs making the cost of lending rise, thereby limiting the amount of overall credit extended

What is best for the market?

- Collections practices must be pursued in recognition of broader market and institutional interdependencies that exist
- Our objective is to ensure that collections activities support overall management of systemic risk

There are 6 key phases of the collections process that are relevant to ethical collections practices

1	**Initial borrower agreement**	▪ Initial agreement between customer and lender for credit
2	**Pre-delinquency and segmentation**	▪ Proactive outreach to high risk accounts to avoid delinquency ▪ Segmenting borrowers based on risk characteristics
3	**Borrower contact**	▪ Attempts to contact borrowers by telephone, email, postal mail, and in-person visits
4	**Collection/ treatment strategy**	▪ Offering options to and negotiating with borrowers to cure accounts (e.g. payment plans)
5	**Recovery action**	▪ Attempts to recover after failure of collections offers ▪ Seizure of assets (foreclosure, REO, etc.)
6	**Lender-collection agency relationship**	▪ Outsourcing collections operations from lender to a collection agency

Each phases raises potential ethical issues

1 Initial borrower agreement

- Incomplete or misleading disclosure of collections practices

2 Pre-delinquency and segmentation

- Profiling
- Aggressive borrower outreach
- Inappropriate offer

3 Borrower contact

- Aggressive / inappropriate telephonic, physical, email, postal outreach
- Inappropriate communications content
- Misrepresentation
- Ignoring validation requests
- Ignoring legal representation

Each phases raises potential ethical issues (con't)

4 **Collection/ treatment strategy**

- Inappropriate offer or misleading disclosure
- Unfair negotiation
- Communication with third party
- Excessive late fees, seeking unjustified amounts
- Insufficient coaching or misaligned incentives
- Detrimental impact to borrower
- Poor borrower credit education

5 **Recovery action**

- Unjustified asset seizure
- Improperly executed asset seizure

6 **Lender-collection agency relationship**

- Outsourcing unethical collections to agency
- Accepting unethical collections from lender
- Misaligned incentives
- Misrepresentation

Examples of damaging collections practices

BEAR STEARNS

Settled for $28 million when accused of misrepresenting the amounts borrowers owed, charging unauthorized fees and engaging in unlawful and abusive collection practices.

– September 2008

Countrywide Financial

Sued for fabricating evidence (escrow discrepancies) used in a bid to foreclose on a home.

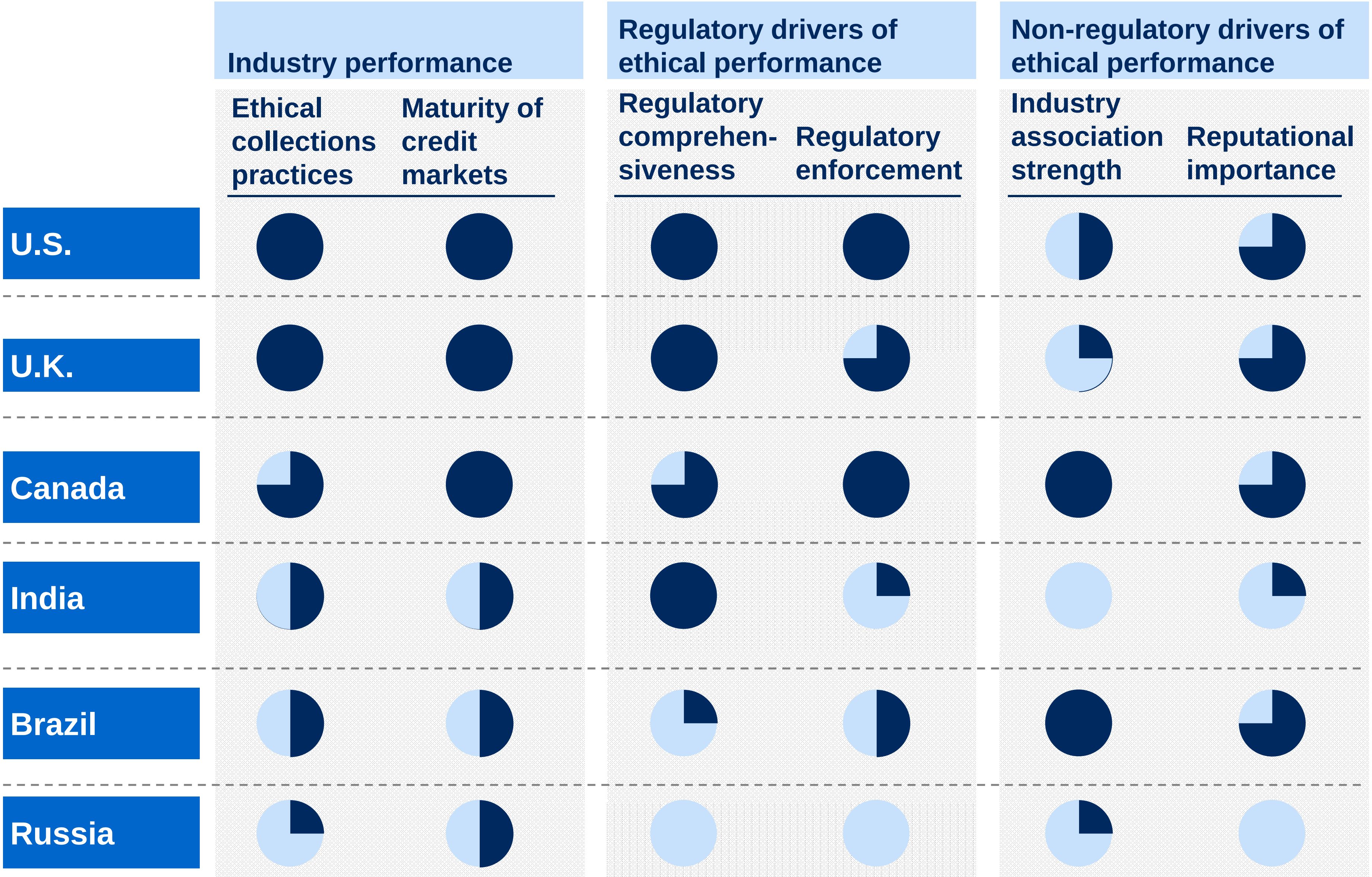
– January 2008

AMERICAN Home Mortgage

Sued for improperly conducted rapid-fire sales of homes within the mortgage pools at "unduly low amounts" in an effort to repay the debt.

– February 2009

Comparison of collections practices in case study countries



Overview of Ethical Collections Practices in the United States

Overall findings:

In general, the U.S. represents near best practice in most segments of the collections value chain

Observance of federal law, due to the maturity of legal system and strict oversight of the financial sector, along with and reputation management drives ethical practices

Findings in key value chain segments:

- ***Pre-delinquency and segmentation***. Discriminatory or inappropriate lending behavior is strictly overseen by governmental authorities and enforced through high penalties
- ***Borrower contact***. The Fair Debt Collection Practices Act (FDCPA) provides largely comprehensive coverage of potential ethical issues associated with borrower contact ethical issues.
- ***Collections/treatment strategy***. Many lenders offer treatments more generous than required by law in order to maintain long-term relationships with borrowers. There is no federally mandated curriculum or incentive structure, but most collectors, lenders and agencies require licensing and/or training and include “right solutions” for the borrower in incentive models.
- ***Recovery Action***. Recovery actions against borrowers are regulated primarily by state law and vary by type of asset. They require collectors to send ample notices and follow a transparent recovery process with clearly defined borrower rights.

Overview of Ethical Collections Practices in India

Overall findings:

Regulations are similar to those of the U.S., but unethical practices remain common due to poor government oversight, limited consumer protection advocacy, and an ineffective legal system

Recently, due to international pressure, the Reserve Bank of India (RBI) has begun instituting steep fines for collections violations

A major industry transition is now underway

Findings in key value chain segments:

- ***Pre-delinquency and segmentation***. Most common issues involve lenders not publishing terms and fees of loans in local state languages. Pre-delinquency offers are nto common.
- ***Borrower contact***. Most common violations have been contacting borrowers at unreasonable times and hiring local gangs to intimidate borrowers at the workplace or home.
- ***Collections/treatment strategy***. Regulations clearly state that collectors may not threaten, use physical violence, communicate with third parties, or seek unjustified amounts. While most agencies do not directly violate these regulations, some outsource collections activities to local gangs known for using these techniques. RBI mandates a collector certificate training course, but enforcement is poor and there is no standardized curriculum. Borrower financial education is typically not provided.
- ***Recovery action and lender-collections agency relationship*****.** Problems exist with collectors inappropriately seizing assets and relying on violent gangs

Comparing developed and emerging market practices

Key Learning's from Case Studies

- In general, **collectors in the developed more actively consider ethical issues and integrate into operations** than collectors in the emerging markets. Laws vary by country, but similar guidelines exist in the developed world for addressing ethical collections practices
- **Collections practices in emerging markets vary** significantly. Although instances of irresponsible practices occur globally, they occur with more frequency and intensity in emerging markets
- **Differences in political and legal context partially drive the variation in developed and emerging market practices**. Comprehensive legislation supported by mature enforcement mechanisms has guided collection practices in the developed world
- **Industry-associations have played an integral role** in providing the resources and support to abide by responsible standards. In emerging markets these associations have begun to fill a regulatory enforcement gap

Guiding principles for ethical and responsible collections

1 ***Invest in a transparent relationship with the borrower***

2 ***Interact with the customer in a fair and respectful manner***

3 ***Develop systems, infrastructure, and relationship with external stakeholders to support ethical practices***

Guiding principle 1: Examples practices

1 ***Invest in a transparent relationship with the borrower***

- Disclose all lending and collections practices clearly in the initial borrower agreement
- Educate borrowers on ways to avoid delinquency in the future
- Proactively offer borrowers reasonable, transparent options to avoid over-indebtedness or repossession

Guiding principle 2: Examples practices

2

Interact with the customer in a fair and respectful manner

- Do not discriminate
- Do no contact borrowers with unreasonable frequency
- Contact borrowers during reasonable hours
- Do not use physical violence or threatening / inappropriate language
- Do not unduly reveal debt information to third parties

Guiding principle 3: Examples practices

3 ***Develop systems, infrastructure, and relationship with external stakeholders to support ethical practices***

- Do not outsource unethical practices
- Do not manipulate legal or political institutions to condone irresponsible or unethical practices
- Develop internal systems to audit practices to ensure compliance with ethical guidelines
- Train collectors in ethical practices and incentivize responsible behavior

There are four potential models for encouraging adoption of ethical standards

Regulation
- Offers the greatest degree of control over defining acceptable practices
- Success is dependent upon government and legal enforcement (e.g., fines)

Industry associations
- Model is opt in and involves more self-enforcement than regulation
- Borrowers may have no impartial arbiter when unethical actions occur
- Associations may publicize membership to promote adherence to standards

Self-motivation (reputation risk management)
- Self-imposed ethical standards
- Least degree of control over acceptable practices

“Stamp of approval”
- An independent organization that develops acceptable practices and rates collectors on compliance
- Leverages an impartial authority and industry pressure for compliance
- Role is sometimes played informally by media

Abiding by the "Principles of ethical collections" practices have the potential to create value for collectors as well

Benefits

- Fewer lawsuits from borrowers
- Fewer penalties for violating regulations
- Potentially greater payment amounts
- Fewer costly recovery actions (e.g. foreclosures)
- Improved reputation among potential borrowers
- Lower existing borrower attrition

Costs

- Potentially fewer RPCs
- Smaller set of negotiation and treatment options
- Potentially lower recoveries
- Greater training and incentive-related costs
- Higher-cost recovery procedures

Next steps

- How can the guiding principles be used as a basis to develop global standards for ethical collections around the world?
- What are the implications of ethical collections standards for different asset classes?
- How can we mobilize and facilitate broad-based dialogue across stakeholder groups to develop a path to implementation?