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1

Consumer Credit Management: An Introduction

This book is about the management of consumer credit; that is, the methods and practices employed by financial services organizations to manage the credit relationships they have with their customers. It covers the theory underpinning credit management and the practices employed by real world organizations to deliver their products and services to the general public.

1.1 Who should read this book?

This is a specialist book, but not an overtly technical one. It is suitable for anyone with an interest in the granting and management of consumer credit who wishes to know more about the processes involved. The reader may be a student of economics, banking and finance, business studies or some similar course of study, a university researcher or a professional working within the financial services industry. The book is also suitable as a reference text for professionals from other areas who are interested in how credit agreements are managed; for example, financial journalists, debt advisors and members of the legal profession.

Given the broad readership, few assumptions have been made about the reader's prior knowledge. The aim has been to keep the language simple and for any technical terms to be thoroughly introduced and explained as required. Credit granting is a numerate discipline and some aspects of credit management can involve complex mathematics. However, the principles of credit management can all be explained without recourse to complex formulas or equations. Therefore, the main body of the text is completely free from any symbols or formulas. A more detailed explanation of the mathematical tools used in credit management is provided in the appendices.

1.2 Structure and content

This preliminary chapter covers introductory material and lays the groundwork for the remainder of the book. The nature of consumer credit is

discussed, the most common forms of consumer credit are described and the different types of organization that provide consumer credit are introduced. The 'five phase credit model' is also introduced, describing the way in which credit providers manage relationships with individuals over time.

Chapter 2 discusses the environment in which consumer credit management takes place. It begins by introducing the business functions required to operate a successful consumer credit business. These functions are then discussed within the context of the different organizational frameworks that credit granting institutions can adopt in support of their strategic objectives. Legal and ethical aspects of credit and debt are also discussed in this chapter.

Chapters 3 through 8 discuss the role of credit management within each phase of the five phase credit model. Chapter 3 begins with the marketing of credit, and describes how a product proposition is put together and delivered to market through the implementation of an appropriate marketing plan. Particular emphasis is placed on the use of direct marketing to target prospective customers on a one-to-one basis. Chapter 4 describes how consumer behaviours are predicted, and how these predictions are used to make decisions about how relationships are managed. In particular, scoring and segmentation are introduced. These are two of the most widely used methods for predicting behaviour in consumer credit markets and are used in many different areas of credit management. In Chapter 5 the customer acquisition process is examined; covering issues such as application processing, credit scoring and the role of credit reference agencies. Chapter 6 is about customer management and the actions that can be taken to maximize the return generated from customers over the lifetime of the relationship with them. Chapter 7 discusses early stage delinquency (collections) when a customer is not seriously in arrears with their repayments and there is some hope of salvaging the relationship with them. Chapter 8 looks at the later stages of delinquency and debt recovery, covering topics such as the use of third party debt collection agencies and legal action to recover unpaid debts.

Chapter 9 covers fraud. The different types of fraud are discussed, along with the actions that can be taken to mitigate against them. The tenth and final chapter discusses provision and capital requirements. A technical discussion about the processes involved in developing models of customer behaviour is contained in Appendix A.

The principles underpinning credit management and the practices employed by credit managers are largely universal. Therefore, the book has been written from an international perspective. For purposes of convenience, all financial values are quoted in US dollars.

1.3 The nature of consumer credit agreements

Ideas of credit and debt are ancient. We live in a society that is, and always has been, heavily reliant on formal and informal credit-debt relationships. We have all borrowed items from and lent things to friends, relatives, neigh-

bours and colleagues. Everyone understands the idea of ‘you scratch my back and I’ll scratch yours’ and the network of favours and goodwill that oils the relationships between us at home, work and in society at large. Even the giving of gifts leads to a credit-debt relationship, creating an obligation on the one who has received a gift to reciprocate at some later time. It has also been suggested that an understanding of such relationships, and ideas of debt and obligation, may have been one factor that enabled modern humans to supersede Neanderthals as the dominant primate species (Horan et al. 2005).¹ At some point in early human society individuals began helping one another to hunt, lending tools and food to each other, caring for each others children and the sick, and so on. These tasks were undertaken with the understanding that they created an obligation that would be reciprocated. This meant that people were better able to overcome short term hardships, leading to greater survival rates and an increased population. The Neanderthals may have been unable to grasp such concepts and were therefore not able to benefit from the advantages that such credit-debt relationships provided.

A consumer credit agreement is just one form of credit-debt relationship that reflects a formal monetary commitment between two parties that is recognized as a legally binding contract. One party (the lender/creditor) provides funds in the form of cash, goods or services, to the other (the borrower/debtor), who undertakes a commitment to repay the debt at some point in the future. For the purposes of this book we restrict the definition of consumer credit to cover only credit agreements where the debtor is an individual. It does not matter what the purpose of the credit is, the amount of credit, the length of the agreement or anything else. The key thing is that the responsibility for the debt lies with an identifiable person, not a company or some other type of institutional entity. This is a broad definition of consumer credit. It is worth pointing out that many observers adopt a more restricted definition; in particular, lending secured against an individual’s home (a mortgage) is traditionally classified as a different category of borrowing and therefore, not consumer credit.² While there are some features of mortgages that differentiate them from other types of individual borrowing there are also many similarities. From a management perspective many of the principles of consumer credit management can be applied across all forms of individual borrowing. That is not to say there are not important factors that differentiate one type of credit from another, or that there are not certain practices and legal requirements that apply to specific types of credit, but that many of the general principles by which credit is granted and the practices used to manage it are universal and can be applied regardless of the type of credit in question.

Consumer credit comes in a variety of different forms, all of which can be described in terms of the following features:

- **Secured or unsecured.** Credit is secured if the credit agreement details specific assets the lender can take in lieu of the debt should the borrower default; for example, their home or car. Otherwise, the credit is unsecured.³

- **Amortized or balloon.** Credit is amortized if debt is repaid in installments covering both interest and capital, so that by the end of the agreement the debt has been fully repaid. With balloon credit the debt is repaid in full at the end of the agreement. Interest may be paid at regular intervals throughout the agreement or as a single payment at the end. Credit agreements where irregular repayments are made are also defined as balloon (Smullen and Hand 2005 p. 30) as are credit agreements where the final payment is greater than all previous payments (Collin 2003 p. 28).⁴
- **Fixed sum or running account.** A fixed sum credit agreement is where a known amount of credit is advanced (usually at the start of the agreement). When the debt has been repaid the agreement is terminated. With a running account agreement the amount of credit is not set when the agreement is made, but a credit facility is made available. The outstanding debt fluctuates as new credit is extended and repayments are made. Running account agreements are also known as open-ended credit agreements or revolving credit agreements.
- **Unrestricted or restricted.** If credit is obtained in the form of money, that can be spent however the borrower wishes, then the credit is unrestricted. If credit is restricted it can only be used to obtain a limited range of goods or services; that is, credit is provided to buy specific items which are then paid for on credit terms.
- **Credit sale, conditional sale or hire-purchase.** These features apply only to restricted credit agreements. If goods are sold on a credit sale basis they become the immediate property of the customer. The merchant can not reclaim/seize the goods if the customer subsequently fails to repay their debt. With a conditional sale, ownership of goods transfers to the borrower only when the terms of the agreement have been complied with.⁵ Therefore, the lender can repossess the goods should the terms of the agreement be broken. Hire-purchase is similar to conditional sale, but the important difference is that the customer is only hiring the goods with an option to buy at the end of the agreement.⁶ Therefore, the hirer can choose not to exercise their option to buy and return the goods. With a conditional sale the borrower is committed to the purchase; the goods can not be returned once the agreement has been signed.
- **Debtor-creditor or debtor-creditor-supplier agreement.** A debtor-creditor agreement exists where the transaction that led to the creation of the credit agreement involves only the debtor and the creditor. A debtor-creditor-supplier agreement exists when goods or services are purchased from a merchant, with credit provided by a third party. The purchaser is then indebted to the third party not the merchant. In many countries the distinction between a debtor-creditor and debtor-creditor-supplier agreement becomes important when there is a dispute over the

goods purchased. With a debtor-creditor-supplier agreement the credit provider has joint liability for the goods. For example, if you purchase a television using a credit card, a debtor-creditor-supplier agreement will exist because the card issuer is providing the credit – not the retailer.⁷ If the retailer subsequently goes bust the card company will be liable should the television prove faulty within the warranty period.

Table 1.1 shows the types of consumer credit offered by most large credit granting institutions.⁸ However, it is important to note that the features in the ‘Typical features’ column in Table 1.1 are just that – typical. It is always possible to find a lender offering something atypical. Nearly all personal loans are amortizing, but a few are not. Most credit cards provide an unsecured form of borrowing, but there are some, where the card issuer will demand that customers who have a poor credit history provide a cash deposit as security.

It can also be argued that Table 1.1 presents a somewhat traditionalist view. As the technology employed by lenders has become more sophisticated many credit providers have begun to move away from the idea of a set of individual credit products provided to customers on a piecemeal basis, towards a holistic view that considers all of the financial products and services that an individual requires. Today, there are offset loans that take into account money the borrower has in their savings accounts to calculate a reduced amount upon which interest is charged. There are credit cards that give the user the ability to pay for high value purchases over a fixed period of time in the same way as an installment loan, as well as providing revolving credit facilities for low value purchases. There are also home equity lines of credit (commonly abbreviated to HELOC) that combine credit secured against one’s home with current account, overdraft and short term loan facilities. This trend is likely to continue, and it is probable that in future consumers will simply be offered a ‘credit account’ that provides for all types of personal borrowing, be it a mortgage to buy their homes or retail credit to purchase a new kitchen appliance. The customer will simply choose the credit option and associated repayment terms that best suit their current circumstances at the point of purchase. However, this is not yet reality, and nearly all consumer credit can be classified as falling into one of the product categories within Table 1.1.

All credit agreements possess three additional features which can be used to differentiate between different products of the same type:

- **The amount of credit.** For fixed sum agreements this is the sum lent at the outset of the agreement. For running account agreements the amount will vary up to a maximum amount determined by the customer’s credit limit.
- **The term (length) of the agreement.** For fixed sum agreements this is the time between a credit agreement being entered into and the date

Table 1.1 Types of consumer credit

Credit product	Also known as ¹	Typical features
• Repayment mortgage	• Amortizing mortgage	• Secured on home • Amortizing • Fixed sum
• Interest only mortgage	• Balloon mortgage	• Secured on home • Balloon • Fixed sum
• Unsecured personal loan	• Installment loan • Installment plan • Signature loan	• Unsecured • Amortizing • Fixed sum
• Secured personal loan	• Installment loan • Installment plan • Title loan	• Secured on home, car or other asset • Amortizing
• Retail credit (including motor finance)	• Retail installment plan • Retail installment credit	• Unsecured • Amortizing • Fixed sum • Restricted
• Credit card ⁴	• Bank card • Universal credit card	• Unsecured • Amortizing or balloon ⁵ • Running account • Restricted (purchases) and unrestricted (cash withdrawal) ⁶
		• Restricted • Credit sale • Debtor-creditor
		• Restricted • Credit sale • Debtor-creditor
		• Unrestricted • Debtor-creditor
		• Fixed sum • Unrestricted • Debtor-creditor
		• Credit sale, conditional sale ² or hire-purchase • Debtor-credit-supplier ³
		• Credit sale (purchases) • Debtor-creditor-supplier (purchases) ⁶ • Debtor-creditor (cash withdrawal) ⁶

Table 1.1 Types of consumer credit – *continued*

Credit product	Also known as ¹	Typical features
• Store card ⁴	<ul style="list-style-type: none"> • Retailer card • Credit card 	<ul style="list-style-type: none"> • Unsecured • Amortizing or balloon⁵ • Running account
• Charge card ⁴	<ul style="list-style-type: none"> • Credit card 	<ul style="list-style-type: none"> • Unsecured • Balloon • Running account
• Overdraft		<ul style="list-style-type: none"> • Unsecured • Balloon • Running account

Notes:

1. Some types of consumer credit are known by different names in different regions. Standard UK terminology is used in the credit product column.
2. In the UK most (non-motor) retail credit is granted on a credit sale basis. In the US conditional sale agreements are more common. Motor finance is usually provided as a hire-purchase agreement.
3. Retail credit is often provided by a third party such as a bank or finance house, but there are no reasons why retailers can not provide credit if they wish.
4. In some regions 'credit card' means any type of card account. In others 'credit card' refers to a revolving account that can be used to purchase goods in a range of stores (such as VISA and MasterCard cards). The term 'store card' is used to refer to cards that can only be used in a single store.
5. These products are both amortizing and balloon. This is because the customer has the choice to repay all the credit at once, or to make regular payments of varying amounts.
6. Goods purchased using a credit card represent a form of restricted credit. This is because although the range of goods and services is very extensive, there are some things that can not be bought with a credit card. However, most credit cards can also be used to make cash withdrawals which is an unrestricted form of credit (Dobson 1996 p. 285). Credit card purchases create a debtor-creditor-supplier relationship while cash withdrawals create a creditor-debtor relationship.

when the final repayment is made. For running account credit this is the date when the facility is withdrawn or reviewed, with the parties having the option to terminate or renew the agreement.

- **The cost of credit.** All commercial lenders apply charges to cover their costs and to allow them to make a return on their investment. This includes interest (the finance charge) that accrues over time, but also includes arrangement fees, transaction fees, annual fees, option to buy fees and so on. Sometimes credit may appear to be provided free of charge – something often seen in the retail sector where goods are routinely offered on ‘interest free’ terms. In reality there is no such thing as interest free – the credit provider’s costs are factored into the price. If interest free credit was not available the merchant could sell the goods at a lower price and still maintain the same level of profitability. The APR (Annual Percentage Rate) is a legally defined way of representing the cost of credit in a standardized form.

1.4 Credit granting institutions

The vast majority of consumer credit is provided by the following institutions:

- **Banks.** Historically banks have been categorized by the type of customers they deal with and the services they offer. Merchant banks dealt mainly with international and corporate finance, while retail banks⁹ provided current account and loan facilities to individuals and small to medium-sized businesses. Today, most large banks have a mixture of merchant and retail interests. The main providers of retail banking services have also diversified into other areas of financial services, and now offer a wide range of products including mortgages and credit cards, as well as insurance, savings accounts, pensions and other types of investments.
- **Saving and loan associations** (building societies in the UK, Ireland and Australia). These are mutually owned profit making organizations that traditionally provided mortgages, funded by the savings accounts of their members. Modern saving and loan companies now offer broadly the same range of financial services as retail banks.
- **Credit unions.** Credit unions are mutually owned financial cooperatives that have traditionally shared many features with saving and loan associations. Credit unions are owned by their members, with the funds contributed by members used to supply credit to other members.¹⁰ Credit unions are usually created around specific interest groups sharing some ‘common bond,’ such as members of a trade union or residents of a town or city. Consequently, many credit unions operate on a relatively small scale compared to the major banks and saving and loan com-

panies. However, some of the largest US credit unions have hundreds of thousands of members and billions of dollars worth of assets. US credit unions offer a wide range of credit products including mortgages, personal loans and credit cards and are known for offering competitive credit terms because they are run on a not-for-profit basis and enjoy a tax exempt status. In other countries the popularity of credit unions varies enormously in terms of the number of members, the average size of unions, and in the range of products they offer. In Ireland for example, about 45 percent of adults are members of credit unions. In the UK the figure is only around 1 percent (Goth et al. 2006 p. 1).

- **Finance houses (finance companies).** These organizations provide consumer (and sometimes institutional) credit, but not savings or deposit accounts. Their lending activities are funded by commercial loans obtained from merchant banks or other large financial institutions. Finance houses mainly provide credit in the form of secured and unsecured personal loans, hire-purchase agreements and card accounts. Some large finance houses also act as third party credit providers, acting on behalf of retailers and other service providers for the provision of store cards, retail credit and hire-purchase agreements.

From a consumer perspective there is very little difference between the financial products offered by these four institutions. What differentiates them is ownership, the objectives that drive their activities and the legislation under which they operate. Banks and finance houses are almost always driven by the profit motive, aiming to maximize shareholder return. Saving and loan associations are profit making organizations, but look to maximize the benefits to their members. Credit unions are also member owned but non-profit making. Banks, saving and loan associations and credit unions are all categorized as deposit taking institutions. This means that as well as providing credit, they also provide current accounts and/or savings accounts. This puts a number of legal obligations on them to ensure that they can maintain their liquidity so that depositors' funds are protected. Finance houses do not offer such services, and therefore tend to be subject to less stringent regulatory requirements than deposit taking institutions.

Between them banks, saving and loan companies, credit unions and finance houses account for the vast majority of consumer credit throughout the world. Other types of credit granting institutions do exist, such as mail order catalogue retailers, pawnbrokers, door-to-door lenders, cheque cashing services and payday lenders. However, most of these operate on a small scale, specialize in providing credit to those on low incomes and/or who have a poor credit history, and account for only a very small proportion of the total consumer credit industry.¹¹

1.5 The five phase credit model

All credit agreements represent a relationship that displays different characteristics and behaviours as the relationship develops over the term of the agreement. Consequently, different actions are required to maximize the value of the relationship at different times. Many observers discuss the management of credit agreements within the context of the credit cycle (or lifecycle)¹² with a credit agreement existing in one of a number of phases during its lifetime (McNab and Wynn 2003 p. 11; Bailey 2004 p. 5; Finlay 2005 pp. 142–3). For the purposes of this text a five phase model of the credit cycle is adopted, as shown in Figure 1.1.

Each phase is characterized by a number of different activities undertaken by the borrower or the lender, and in each phase the lender looks to facilitate different types of customer behaviour. The goal during phase one is to encourage creditworthy people to apply for credit. Creditworthiness is primarily based on the likelihood that someone will repay the credit they are provided with, but it also captures other aspects of customer behaviour such as the potential revenue they are likely to generate and the opportunity to cross sell them additional products and services. To put it another way, a creditworthy customer is someone who is likely to generate a positive contribution to profit and an uncreditworthy customer is someone who is likely to generate a loss. The measure of someone's creditworthiness is not an absolute measure. Every lender has different operational overheads, prices their products differently and estimates profitability in different ways. Therefore, each lender has their own perspective on how creditworthy someone is, and it is quite possible that someone who is deemed uncreditworthy by one lender is considered creditworthy by another.

If someone responds to promotional activity by applying for the product the relationship moves to phase two. At this stage more information about the applicant usually becomes available, allowing a more accurate and up-to-date assessment of creditworthiness to be made. A decision will then be made whether to accept or decline the credit application. Decisions will also be taken about the terms of business (the terms and conditions) to offer successful applicants; that is, the credit limit, APR, term of the agreement and so on. If the applicant agrees to the terms, any paperwork that is needed for a legally binding credit agreement will be produced and passed to them to sign. Once the agreement has been signed some form of account record will be created (usually within a computerized account management system) to maintain details of the current and historical status of the agreement. The account record will then be used as the basis of phase three – the customer management phase of the credit cycle – as repayments are made, further credit is advanced and other products and services are marketed to the customer.

Phases four and five are only required if the customer breaches the terms of the agreement, causing their account to become delinquent. At this point the

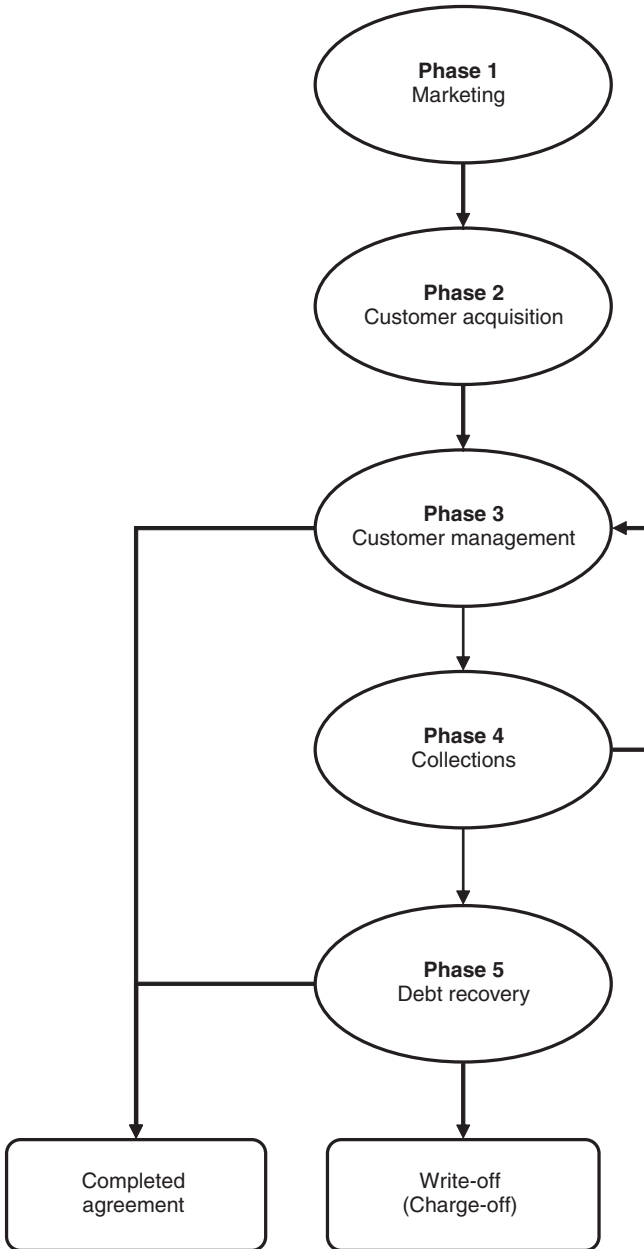


Figure 1.1 The five phase model of credit management

relationship enters phase four where collections action is taken in an attempt to nurse the account back to an up-to-date status – returning it to phase three. At this stage the relationship is still viewed as a positive one, and much effort may be expended to try and persuade the customer to pay the arrears on their account. However, if the customer consistently fails to comply with the terms of the credit agreement, falling further behind with their repayments, the relationship moves to phase five – debt recovery. In phase five the objective is no longer to maintain a good customer relationship, but to recover as much of the outstanding debt as possible before terminating the agreement.

A credit agreement ends in one of two ways. It may end naturally when the debt has been repaid according to the terms of the agreement and the account closed, or if debt recovery action fails to recover the debt it is written-off (charged-off).¹³

Figure 1.1 shows the five main areas of credit management; the initial marketing of products and services, the acquisition of new customers, customer management, collections and debt recovery. In order to maximize their return a lender must manage all of these areas effectively. In addition, there is a need for an integrated strategy across each of the five phases to ensure consistency and that contradictory action is not taken within different phases. For example, it is generally not a sensible idea to try and promote further credit to customers whose accounts are in debt recovery because they have failed to honour the terms of their existing agreement. Therefore, marketing departments need to have knowledge of customers' accounts, not just to determine if someone already has the product, but also to see how their account is performing.

1.6 The role of credit management

A key point to note from Figure 1.1 is that movement between all five phases is driven by consumer behaviours. The customer chooses whether or not to apply for the product. If offered credit they then choose whether or not to accept the terms under which it is offered. If collections action is required, this is because the customer has, for what ever reason, chosen not to pay and so on. In order to move customers into or out of various phases, the activities of the lender are geared towards trying to persuade (or in some cases force) the customer to behave in a certain way. Therefore, it is possible to sum up the framework within which credit management operates, with all of the key activities, processes and systems employed by lenders, focused on the following.

1. Predicting how individuals will behave in future.
2. Undertaking actions in response to these predictions that maximize the organization's objectives, by attempting to influence (manage) the behaviour of the customer.

So, for example, when someone applies for a loan, the lender is interested in identifying whether the person will:

A. Repay the credit advanced to them according to the terms of the credit agreement, generating a positive contribution to profits.

or:

B. Default on the agreement, leading to a negative contribution to profits.

The lender will acquire information about the applicant from a variety of sources, such as the application form completed by the applicant and a credit report supplied by a credit reference agency. This information will then be used to predict the likelihood of behaviour A or behaviour B occurring. If the chance of the debt being repaid is high enough, then the customer will be offered the opportunity of signing a credit agreement and receiving the funds they applied for. However, if it is likely that the individual will default on the agreement, then their request for credit will be declined – thus removing the individual's option to default in the future.

Of course there are a host of other activities undertaken in the management of credit agreements. Large numbers of people are involved in maintaining the physical infrastructure required to deal with customers and to enable suitable actions to be taken in response to specific customer behaviours. IT systems are required to monitor the status of the business to see how well it is performing and to understand the consequences of past decisions in order to facilitate better decisions making in future. Legal expertise is required to ensure compliance with relevant legislation, and accounting and finance functions manage the cash flows within the business and produce company accounts. However, these are all secondary to the two main activities of predicting how people will behave, and then taking appropriate action in order to manage relationships with individuals effectively.

1.7 Chapter summary

Consumer credit management is about predicting and controlling the behaviour of customers in order to meet the objectives of the credit provider. The relationship between individuals and credit providers can be represented by the five phase model of credit management, where each phase is concerned with different types of individual behaviour. In phase one the goal is to identify suitable individuals and to encourage them to apply for the product. Phase two deals with processing applications for credit, and the corresponding decisions and processes that need to be undertaken to facilitate the creation of a credit agreement. In phase three the relationship with the customer is managed in order to maximize the contribution from the

customer. For example, reviewing the credit limit granted to a credit card customer and looking for opportunities to cross sell additional products and services.

When a customer does not comply with the terms of a credit agreement they move to phase four, collections, where action is taken to try and recover the account to an up-to-date status. If this fails then the relationship enters the final fifth phase, where action is taken to recover as much of the outstanding debt as possible before terminating the agreement. In order to run a successful consumer credit business, all of these five areas must be managed in an efficient, integrated and coherent way.

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