White Paper

Early Warning System for SME Portfolio Management
A strategic capability to win in the marketplace

The SME segment has high vulnerability and sensitivity to macroeconomic changes. Thus, a deterioration in macroeconomic condition can easily push the SME lending portfolio towards risk of distress or default. At the same time, regulatory requirements could apply pressure on organisations to grow their portfolios despite the growing concern around increase in delinquencies.

In such context, being able to understand the financial situation of SMEs beforehand and then to act upon it with foresight has become a definitive source of competitive advantage.

Prevention is better than the cure

Now more than ever, pre and early delinquency management strategies play a key role in managing debt. Forward-thinking lenders are making the transition from a reactive environment to one that incorporates a proactive pre and early collections activity to try and reduce the flow of cases into the collections system.
The power of an Early Warning System
An Early Warning System (EWS) focuses on preventive and very early collections phase within the customer life cycle. It incorporates the practice of proactively identifying and contacting SMEs who are currently up-to-date or just became past due but have a predicted high risk of becoming (seriously) delinquent in the very near future.

An EWS delivers early signals on expected deterioration of the client’s financial situation and integrates internal data as well as external data to increase its effectiveness.

Approaching the deadline for the payment, warning indicators are created and distributed across the risk management systems to act proactively and, if necessary, to get in contact with the client before any trouble occurs. The aim is to aid identification of customers likely to become (more) delinquent and target appropriate actions that:

- Encourage payments ahead of potential delinquency or becoming increasingly delinquent
- Minimise “at risk” exposure and non-performing assets
- Manage potential high risk customers with sensitive treatment at the earlier stage of the process

The role of EWS within the customer life cycle

- Underwriting
- Customer Management monitoring
- Pre default Management
- Default Management
- Write-off Management

Mainly strategic perspective aimed at preventing future delinquency
Identify changing behaviour patterns
Control exposures and product offerings
Contact to offer advice and guidance
Key components of a comprehensive EWS

1 - Knowing your customers to identify preventive collections actions

Establishing a holistic view of the customers is a key element in the EWS. For many organisations the internal information is the only perspective they have on a SME. Some of this information is provided at the point of application and may be out of date.

Many organisations continue to use this potentially out-of-date view in their on-going risk assessment procedures based on the assumption that either changes have not occurred, or that they have occurred but with minimal impact. However, the reality is that application information alone is insufficient for a pre-delinquent strategy to be effective.

2 - Using advanced analytics to enhance your strategies

The development of a robust model, which combines internal and external data can enable a rapid response to changing behaviour and give sufficient time to take remedial actions on relevant customer base.

Predictive models used in the EWS are different from the scorecards used in other phases of client life-cycle. EWS models are categorised by some specific features like shorter outcome period and usage of additional data elements.

Some additional warning triggers or scores could be incorporated from Credit Bureaux as well. They can be integrated into the statistical model or incorporated as overlays on top of the model outcome.

Sample Strategies: Signals, Actions and Objectives graded by Level of Riskiness

<table>
<thead>
<tr>
<th>Risk Class</th>
<th>Signals</th>
<th>Actions</th>
<th>Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low risk</td>
<td>• Regular behavior</td>
<td>• Constant monitoring in order to identify promptly signs of deterioration</td>
<td>• Verify periodically the change of the accounts status</td>
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</tbody>
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| Medium risk| • Serious and long-term anomalies but the profile is likely to improve | • Improve the risk profile through:  
  - Request of new guarantees  
  - Payments plan review  
  - Review terms of new offers | • Higher recovery in pre-collection  
  • Reducing exposure |
| High risk  | • Deterioration of the risk profile | • Agree repayment and/or obligation to repayment plans  
  • Request of new guarantees  
  • Stricter risk policies in application | • Higher recovery in pre-collection  
  • Progressive and full recovery of the exposure |

3 - Better interaction with your customers

An appropriate customer classification through EWS ensures that the customer interaction is matched to the customer’s situation, making these touchpoints relevant and supportive.

What underpins the pre-delinquency strategy is the offer of financial advice and guidance to the customer. It represents an opportunity for the potentially stressed customers to engage with the lender to discuss how they might resolve their current, but as yet undisclosed, financial difficulties.
The Experian Early Warning System approach

We use an integrated method that involves market-proven expertise, best utilisation of data and advanced analytics, covering all elements of the process:

- **Diagnostic**
  - Initial gap analysis focused on the revision of the current system and analysis of information availability

- **Data validation**
  - Identification of internal and external data sources that are relevant to the identification of signals

- **Segmentation**
  - Creation of homogeneous groups that can be specifically used for estimating separated models

- **Univariate and multivariate analysis**
  - Correlation analysis of information with the target variable

- **Model development and validation**
  - Application of analytical techniques to obtain statistical models and validate them on an on-going basis

- **Integration processes**
  - Definition of the business strategy to incorporate the EWS into the day-to-day lender’s activities

- **Deployment**
  - The monitoring of results to ensure the impact to the business is aligned with expectations

Having a traditional approach to manage risk is not effective in today’s constantly changing environment and thus should be replaced with new data driven approach based on internal and external data. Financial institutions need to address these questions to be fully ready to adapt to the fast-changing macroeconomic conditions, during current times and even beyond.

1. Does your organisation have a **DATA DRIVEN APPROACH** (based on internal and external data) in place to identify customers at risk of distress or default?

2. Has your organisation implemented a system which is **EASY TO EXPLAIN** through visualisation of final outcomes and data elements?

3. Does your organisation have a **FLEXIBLE** system that provides full control of decisions to your Risk or Collections manager?
Experian’s Early Warning System solution

Our easy-to-implement solution combines multiple data sources, advanced analytical models and a consultative approach to help lenders identify proactive actions using warning indicators in order to generate many benefits.

Adopting a proactive, data and analytics-driven approach can be highly rewarding in terms of:

• Getting paid before the client becomes delinquent
• Increasing self-cure rate in early buckets
• Reduced outstanding volumes, losses and provisions
• Improved customer experience through sensitive actions and communication
• Significant cost savings in collections
• Additional information for risk assessment in Renewals and Customer Management: for example declining applications based on warning indicators or reducing limits; excluding higher-risk customers from up-selling and cross-sell campaigns framework

Contact your Experian representative to learn how Early Warning System can aid you on pre-delinquency strategies within your loan portfolio, optimise your recovery & collection process while supporting your SME customers during the challenging times.
BUSINESS CASE

An Italian Banking Group wanted to launch a pre-collection process based on the prediction of the probability to recover, in order to reduce the number of accounts to be allocated to external collection agencies and improve the quality of the exposures.

Business challenge
The lender recognised that taking a pre-delinquency approach to customers that were thought to be in distress would be beneficial (about 70% of the portfolio was also exposed to other financial institutions) and would enable the management of problematic cases prior to other lenders.

The aim was to establish control also improving customer experience and thereby gain payment commitment whilst the issues were still manageable.

How Experian helped
The first step was to build a decision tree that used a combination of internal and external bureau data that could be applied to non-delinquent customers. The lender used then these segmentation to rank order the customers and assign specific pre-collection strategies.

Benefits
The results included:
• $130m of outstanding amount move back to regular
• Decrease of Cost to Collect by 25% in 4 months
• Loss reduction of $4 million on an annual basis
• Enhancement of Customer relationship and staff competences

BUSINESS CASE

An International Banking Group implemented Early Warning System and strategies to reduce the number of cases to be treated in the recovery process and the overall collection costs.

Business challenge
The bank had robust systems and processes to manage customers who became delinquent in order to recover the outstanding debt and rehabilitate them but the relationship with their customers deteriorated and the organisation was incurring high collection costs.

The bank recognised that a proactive approach, taking action before a customer becomes delinquent, could have an impact on delinquency levels and improve the effectiveness of the collections activity and reduce the exposure of the bank.

How Experian helped
Through the portfolio segmentation and the development of specific forecasting models by product/bucket (from 0 to 1), Experian helped enhance the usage of both the bank’s internal data and Credit Bureau information and define relevant actions for each specific segment.

Benefits
The results included:
• Reduce flow rate into early stage collections by 25%
• The decrease of Cost to Collect by 20% in six months
• The reduction of number of delinquent accounts by 15%
• The optimisation of Customer care process and Attrition level