How to Prevent Defaulting Loans Despite a Potential Recession

lending customer service customer profitability

Summary: History shows that recessions lead to higher default rates among consumers. By predicting and managing delinquency before it occurs, a CFI can increase the lifetime value of existing customers by helping them avoid becoming delinquent.

The city of Baltimore recently failed to notice that a prominent resident was delinquent in their utility payments. Wes Moore, Maryland's governor-elect, owed the city $21,200 for 18 months of unpaid water and sewer charges. The city admitted that it doesn't have a process or appropriate mechanisms to spot and collect delinquent bills.

With a looming recession and American consumers carrying $2T more in debt than before the COVID-19 pandemic, lenders are wise to be wary of a potential uptick in delinquent accounts. Under-managed accounts, like that of Wes Moore, can be harmful for any organization, especially smaller ones, like community financial institutions (CFIs).

But with a strategy referred to as "pre-delinquency management," CFIs can minimize defaults and strengthen their customer base, even in the face of a potential recession.

Spotting the Signs Before It's Too Late

Implementing a pre-delinquency management program starts by switching algorithms to spot early changes in payment behaviors rather than solely flagging late accounts. The following could be signs that a certain customer or account could be heading toward delinquency:

- **Smaller payments or slower repayment.** A sudden reduction in sum or speed of payment is one of the first signs of pre-delinquency. For borrowers with a solid performance history, does current behavior reflect their typical operations or signal strain?
- **Higher-than-typical balances.** While a higher outstanding balance and the accompanied compounding interest are ideal from a profit mindset, balances with a steep trajectory can be a cause for concern.
- **Stress testing to flag borrowers who are "on the edge."** Administering stress tests can be complex, but they help mitigate risks. As part of your loan reviews, examiners will want to see a healthy amount of stress testing, especially for interest rates and operating costs.
- **Look more carefully at Work-in-Progress (WIP), Accounts Receivable (AR), and Accounts Payable (AP) reports.** Spending extra time comparing your borrower's WIP, AR, and AP reports as they relate to past performance can offer unique insights that may otherwise go overlooked. For example, spotting concerns on an AR report can provide a warning of a domino delinquency effect.

Deterring Delinquency

If any of the listed pre-delinquency signs are spotted, the first step is to communicate to senior management or the board. Responses should reflect your CFI's credit profile. Reach out to the customer and begin to form a plan that's empathetic yet actionable.

Just like how no two customers in good standing are identical, customers at risk for delinquency are also unique, and shouldn't all be painted with the same brush. Bulking up customer profiles with additional layers of information can help a CFI better understand and effectively help a struggling borrower on an individual basis.

Management processes may vary by product type, customer history, and proposed solutions. CFIs can focus on demonstrating sensitivity and offering advice while providing options that leave customers feeling understood and appreciated.

In June of 2021, 2.7MM homeowners were behind on their mortgage payments. However, data shows that 77% of the borrowers in forbearance exited with a loss mitigation repayment plan. When multiple options are available, borrowers feel understood and are more willing to work with their lenders to find a solution.

Pre-delinquency Management

By predicting and managing delinquency before it occurs, a CFI can increase the lifetime value of existing customers by helping them avoid becoming delinquent.

Successful pre-delinquency systems also help CFIs abandon outdated and overly strict lending requirements as they gain confidence in their ability to identify customers at different levels of risk.

Simply put, a CFI can experience faster growth and higher revenue by implementing a pre-delinquency system.

NEW PODCAST EPISODE: INCREASING CUSTOMER LOYALTY

It's always a good time to focus on keeping your customers happy and loyal. Tune in to this new episode for tips from the experts at Customer Communication Group as they discuss the do's and don'ts of increasing customer loyalty.

ECONOMY & RATES

Rates As Of: 12/19/2022 09:05AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	4.31	-0.06	4.25
6M	4.68	-0.02	4.49
1Y	4.61	-0.10	4.22
2Y	4.21	-0.10	3.48
5Y	3.70	-0.04	2.43
10Y	3.58	-0.03	2.06
30Y	3.65	-0.09	1.74

FF Market	FF Disc	IORB
4.33	4.50	4.40
SOFR	**Prime**	**OBFR**
4.32	7.50	4.32