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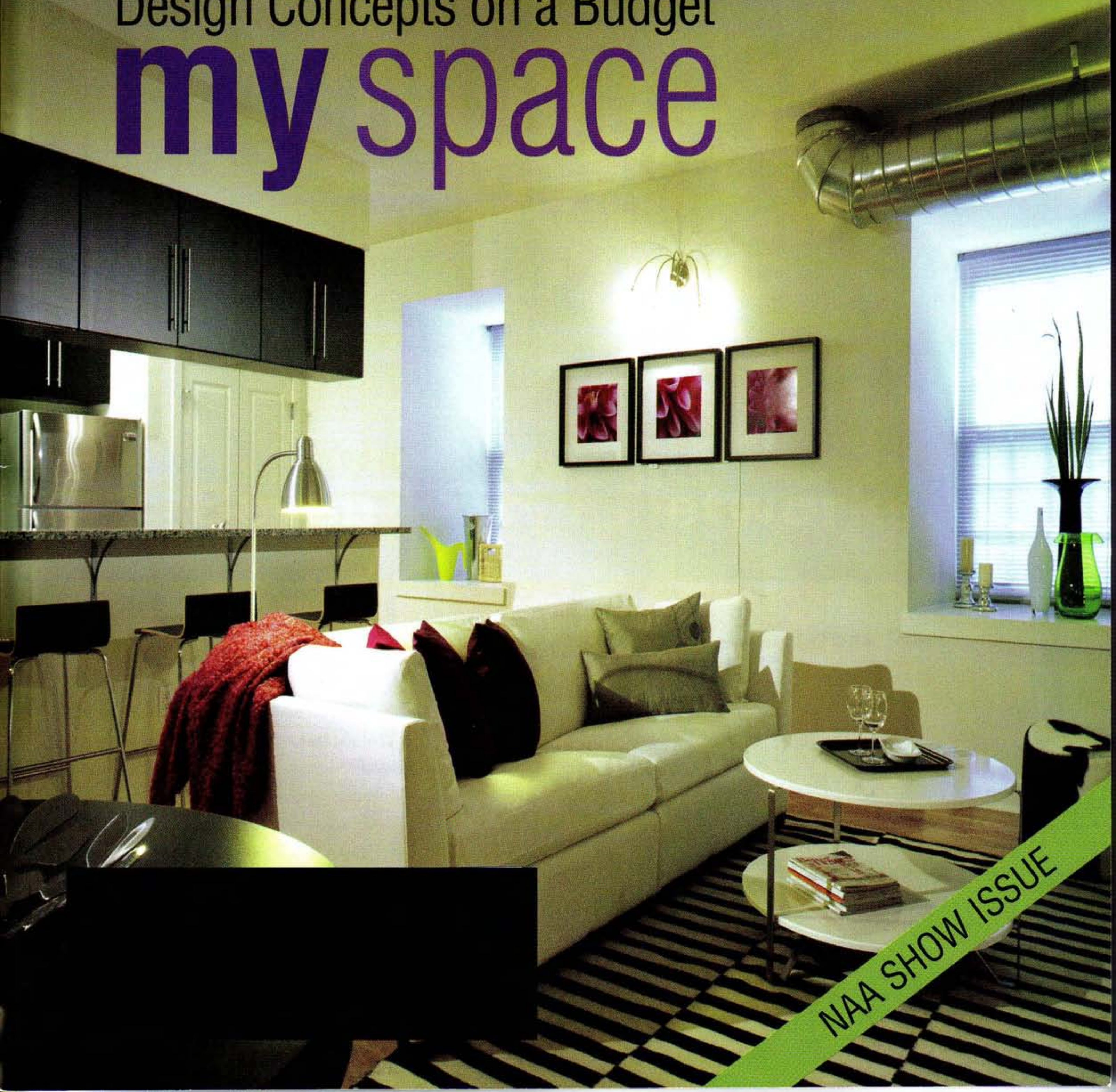

Debt Control

BY JORGE BALDOR

Without a clear strategy or firm set of objectives, companies will be hard-pressed to find the elusive balance between occupancy demands and bad-debt risk tolerance.

Although the science behind resident screening credit score models can be complex, having a clear management company credit policy is not really rocket science.

It merely requires an understanding of the relationship between front-end resident screening and bad debt collections, plus a company-wide "credit culture" commitment to ensure credit extensions are consistent with strategic portfolio and risk-management objectives. An analysis of bad debt will reveal a management company's credit culture and can uncover easily avoidable credit risk.

Build a Credit Culture

The credit values and beliefs of senior management create a credit culture that extends throughout an organization. For some companies, this culture is conveyed in a policy and procedures manual but for others it's not as clear and can be easily misunderstood.

Credit culture influences the entire credit process—from credit risk tolerance during the initial resident screening through tracking delinquency and bad-debt performance. Not having a clear strategy and set objectives can lead to frustrating attempts at finding the elusive balance between occupancy demands and bad-debt risk tolerance.

Too often, front-end screening is seen as unrelated to bad debt. This approach can result in resident approval guidelines being subjectively lowered to satisfy low or declining occupancy. The temptation can be to lower the standards until bad debt becomes the greatest concern. Then, a sudden reversal comes when tightening approval standards cause occupancy to become, once again, the paramount concern.

This seesaw approach can be avoided by coordinating all aspects of the credit process with a credit culture that clearly articulates long-term credit objectives.

Effective portfolio credit management requires an understanding of the information available when analyzing bad debt.

Identify Exceptions

Assessing bad debt begins with identifying the amount of bad debt. With portfolio mergers and inconsistent credit policies in established portfolios, it is not always easy to determine the exact amount of outstanding bad debt. However, it's important to consolidate all bad debts into a single report. An analysis of the prior 12-month period should present enough information to confirm or establish a credit policy.

The most useful auditing tool is an exceptions report to identify the source of the bad debt. Start by isolating the bad debt list into four distinct categories:

1. Those approved by using the portfolio criteria guidelines;
2. Those not properly screened—either screened using an inappropriate screening service level (i.e., screened as occupants instead of as leaseholders) or not screened at all;
3. Those originally denied by the screening process and then overridden by management; and
4. Those denied by the screening process but became leaseholders.

This exceptions report will reveal areas of policy weakness. Those who fall into categories 2 through 4 have the additional burden of exposure to Fair Housing concerns, but are also the most easily corrected. For these, simple training can be effective in avoiding preventable delinquency.

Using this information becomes an integral part of establishing a management company's credit culture. Tracking this valuable data on a quarterly basis will assure ongoing adherence to policy and expose preventable credit risk.

Review Performance

Understanding the bad debt resulting from the category 1 list—those who actually met the portfolio criteria approval standards is important for reviewing your resident screening process. This data helps to formulate a true "whole picture" risk-management solution.

Although all resident screening programs rely on credit bureau reports that are a snapshot of credit performance, two important differences will have a significant impact on the financial success of a portfolio:

1. **Which credit bureau report is being analyzed?** There are three national Credit Reporting Agencies (CRAs); Experian, Equifax and Trans Union. Of these, Experian has the most information applicable to the multifamily industry, including better reporting of housing debts and Public Records—such as bankruptcies, tax liens and civil class judgments (including evictions).
2. **How is the CRA information translated by the screening provider?** Fair Isaac and Company (FICO) or Beacon score models were developed for the credit card and mortgage industry and are not necessarily effective for the apartment industry. Does the screening company's score model go beyond the simple FICO or Beacon scores?

Correct the Credit Culture

Hard to Find: For apartment owners, the ideal balance between occupancy demands and bad debt risk tolerance can be elusive.

Hard to Avoid: The temptation can be to lower screening standards until bad debt becomes the greatest concern.

Hard-Fast Rule: Aim to eliminate avoidable risks and maintain accepted levels of risk.

Another indicator is evidenced by reviewing how true the collection agency bad debt recovery rate correlates to the calculated initial resident screening risk score. Bad debt recovery for those approved with lower initial screening risk scores should translate directly into a higher rate of receivables recovery.

If these do not match, either the screening model is not effective or the collection results do not meet realistic expectations.

Get Past 'Sales Speak'

Overly optimistic collection agency marketing "sales speak" can lead to disappointing results. Statistics have proven that even with advances in technology and, specifically, Internet tracking available to collection agencies, two basic factors remain the best indicators for setting realistic expectations of collection agency results.

The first and most important is the quality of the initial credit screening process. This includes a screening partner that has the ability to provide ongoing reports tied directly to your current collection agency.

The most effective credit culture begins with an understanding of the direct impact of the initial resident screening process and monitoring compliance with the management company credit policies through timely audits.

The second most important factor that impacts successful bad debt recovery is timely file placement with a professional third-party collection agency that specializes in apartment collections.

After the debt has occurred, it is too late to change the screening results for that file. What then becomes the most important tool is having a management credit culture focused on timely bad debt file placement.

The American Collectors Association (ACA) estimates a 16 percent lower chance of recovery for each month that passes without a file being placed for collection.

Typically, after the initial 30-day period following the move-out, a file should be placed for collection unless actual payment has been received or a formal

Any time that credit is extended, a certain level of risk is involved. Successful management company credit culture can be measured through elimination of avoidable risk and maintenance of the accepted levels of portfolio risk. This requires a simultaneous review of both the initial screening and bad debt collection procedures.

payment plan is established.

A collection partner with reporting capabilities to all three CRAs will maximize recovery efforts because the debt becomes exposed to potential owners in their own screening processes.

An ongoing report from the collection agency of days lapsed between move-out and the actual file placement is essential for monitoring management collection objectives.

Having a clear policy for sending files to a collection agency sets site-level expectations based on the overall management credit culture and allows more time to focus on existing and prospective residents.

It will also lead to higher collection results and increased NOI.

See the Whole Picture

Any time that credit is extended, a certain level of risk is involved. Successful management company credit culture can be measured through elimination of avoidable risk and maintaining acceptable levels of portfolio risk for occupancy demands.

This requires a simultaneous review of both the initial screening and the bad debt collection procedures.

These two elements are inextricably related, and trying to make policy decisions based on isolating either will lead to continued frustration.

Having a single partner that can automatically analyze both your screening and collection data and provide these reports creates a true risk management solution and puts your management company at an advantage. ■

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