DO YOU KNOW THE SCORE?

By Martin V. Lavin

If you are an adult and have ever borrowed money, you probably have a numerical "score" you may not know about. And even if you know about it, you may not know what it is or what it means. This is your credit bureau score—or FICO score—or whatever name it is given.

This score has an enormous affect on your life, including job prospects, the purchase of a home or a car and obtaining credit cards.

These are all very important life occurrences and your bureau score will have great impact on what you can finance and even the rate and terms. It's not unusual for apartment landlords and prospective employers to access and use these scores as well. So the impact of credit scores is pervasive and important in our lives.

What is a bureau score? It is a numeric grade assigned to most every borrower by the three credit bureaus. They represent how much credit the borrower has, and how they've paid it in relation to millions of other Americans. Generally, I see manufactured housing borrowers with scores from 400 to 800. Anything under 600 is pretty edgy and above 700 is quite good. Scores above 800 mean the borrower is prompt, consistent and disciplined. I don't see too many 800s on the factory-built side. I do see a lot of borrowers under 600.

Lately, our industry has suffered through its most damaging meltdown since 1974-76. Perhaps after the events of 9/11, this current cycle may be of a greater severity and length than even that earlier cycle. After all, business back then was robust again by 1976 after its peak in 1973. In this latest cycle, we peaked in 1998. Today, we are still not certain we've reached bottom, to say nothing of knowing what the recovery will be or when it will happen.

In understanding how the latest collapse came to factory-built housing, a discussion of bureau scores has become a necessity and cannot be done without understanding credit quality. At its heart, this is the primary factor in the industry's success or failure. No autopsy of the 1999-2001 meltdown can be done without this understanding.

Who needs credit scores?

A well-known industry figure said to me recently "You are too hung up on these credit bureau scores. They are not the end-all of lending." I agree bureau scores are not, by themselves, the sole factor of success. But no successful lender can avoid their use or at least what they represent.

I've seen the 607 customers that I would loan money to and the 740 customers I wouldn't. But bureau scores are not geared to make credit denials and approvals based solely on scores foolproof. Good underwriting requires consideration of factors other than bureau scores to be effective. Industry lenders, in fact, consider many other factors, even though it is expensive to do so.

Some lenders, until quite recently, *rejected* the use of bureau scores.

They had put together proprietary scoring systems based on their own knowledge and beliefs. With these factors, these lenders thought their systems would yield good results. They felt bureau scores gave insufficient knowledge on whether or not to loan. (Interestingly, scores had wide acceptance in other lending sectors, especially real estate mortgages and autos, but was not deemed sufficient for this industry by some.)

Then, as their portfolios originated with these proprietary systems went sour, lenders reluctantly started the search for answers. One of the answers sought was the correlation between these portfolios and bureau scores.

They found that these very poorly performing portfolios consisted of average bureau scores in the 550-590 range. All of the sudden, if bureau scores didn't exactly become the Holy Grail, at least they proved their great power of predictability as to credit quality. Bureau scores are now safely ensconced in the factory-built lending industry's underwriting and pricing structures. We've become believers, if once we doubted.

This doesn't mean *all* decisions should be driven by bureau scores. But does it mean they can be ignored? Only if you like to make decisions based on ignorance as your lending style. In other words, there is too much validity in them to ignore, but too little precision for 100 percent accuracy.

Those who use them exclusively for the entry-level credit granting process will pass on loans they should buy. Those who put great weight on the scores will buy some they shouldn't. I see bureau scores being used to cut people off at the bottom of the credit tier with an auto rejection, say below 600 or 625. I also see them used to determine pricing, for "standard" or "preferred" customers. The only danger here is auto-deny lenders will occasionally pass on a deal they could or should make. No lender I know makes an auto-approve at any bureau score, although as you get into the higher scores it seems that way.

The meaning of scores

Let's examine scores and figure out generally what they mean. Previous lending standards assigned a letter grade to the borrower's credit. While there is no precise or industry recognized correlation, we can use these numbers as a guide:

A = 700 bureau score and above
B = 651-699 bureau score
C = 600-650 bureau score
D = under 600 bureau score

With variations in lending and servicing capability, no sure answer can be given as to where the "safe" loans can be made. Still, we can find some answers by knowing the following facts:

1. The median bureau score of all borrowers in the country is 725.
2. Recently, 23 percent of the borrowing population of the U.S. has scores of 650 or less.
3. Historically, industry portfolios have average bureau scores of 635 to 650 for those buying the general run of factory-built housing business.
4. Prior to 1995, very little paper under 600 was purchased.

In what I consider the seminal arti-

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cle on industry lending, the late Otto Wantuck explored much of this in "The ABC's of MH Loans" (February 1998).

Wantuck's perspective, gathered over a 50-year lending career, had insights that are ignored by this industry at great peril. Its framework, in my opinion, constitutes a starting point upon which to build a program.

Nonetheless, even the information there is subject to the second great danger in the use of bureau scores: Servicing the loan after origination can have greater impact on a portfolio than even a good origination process.

I've seen lenders get into trouble with high 600s and low 700s average portfolios and others seemingly thrive with scores in the mid 650s and slightly lower. An average too much below that enters a danger zone where even high interest rates and guerilla servicing may not save you.

Today, factory-built housing portfolios are closely watched and their performances tracked during their existence. Aside from credit quality, many other factors will impact portfolio performance including fraud levels, loan terms, the economy and a host of others. Generally, over time and with average servicing, here is a basic starting point of facts to consider.

The historic portfolio turn is about 7.5 years, although that has shortened recently. Over the life of the portfolios, the different credit tiers will have the following average annual and lifetime repossession rates (the annual rate multiplied by 7.5 years), assuming competent servicing.

A paper 700 and above = .75 percent annual repos and 5.6 percent lifetime repos.

B paper 650-699 = 2 percent annual repos and 15 percent lifetime repos.

C paper 600-649 = 4.5 percent annual repos and 33.75 percent lifetime repos.

D paper Under 600 = 7 percent annual repos and 50 percent lifetime repos.

The trick to originating a proper combination of volume and safety is to weigh your portfolio carefully. Obviously, we'd all like 700 plus bureau scores, but there are not enough to go around.

Of course, that is what happened in 1995 as many lenders entered the market aggressively. You must make credit concessions to generate any serious volume and many were made. Lower down payments, very long terms and lesser credit quality became standard operating procedures.

The properly weighted factory-built housing loan portfolio should be comprised of the following percentages:

A paper = 20 percent of dollars originated.

B paper = 40 percent of dollars originated.

C paper = 40 percent of dollars originated.

D paper = none.

The math tells us that over the life of the average factory-built housing portfolio, with average servicing, you may have about 21 percent repossessions, or as high as 3 percent a year.

Some years will run greater and others less. While there may have been some raised eyebrows at this level of repos some years back, I know lenders that now believe this figure is too conservative.

My only answer is that credit qual-

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ity and servicing do matter and, like everything in life, the average never seems to be the norm. Variations from all of the above numbers are many and these figures are only meant as a guide.

Credit quality does matter

Consider this final fact that puts factory-built housing portfolios into their proper focus. A recent credit bureau report says general consumer loan portfolios had the following composition: A paper, 60 percent; B paper, 16 percent; C paper, 11 percent; and D paper, 13 percent.

Average consumer portfolios originate a surprising 13 percent of loans in the D category, which are mostly auto paper and very different from this industry. Notice a very high 76 percent of all loans are in the A and B sectors with most of them on the A side.

These numbers show how skewed we still are in the business today. Considering not long ago industry portfolios were much worse, note that if they were similarly constituted as the average consumer portfolio, it would cut our defaults in half. And if we had the same, but eliminated the D paper, we would have portfolio defaults in the 8 percent lifetime range, two-thirds less than we now experience.

Credit quality does matter, big time.

Obviously, if the industry somehow reduced its defaults to anywhere near the level previously described, this would be a very crowded lending contingent. Is that likely to happen? Probably not.

However, things can be done to reduce our present high level of defaults and the high incidence of loan loss severity being experienced presently. (I'll explore this subject in future articles.)

Nonetheless, I cannot stress enough that a street-smart finance company with many field personnel and guerilla servicing can buy and collect paper that would doom a complacent lender.

Even for the savvy ones, when they descend into the lower C's and all D's, default overload is a risk. Bureau scores have been proven to have a very high predictability of defaults. With portfolios filled with sub 600 paper, a lender will likely experience 50 percent or more defaults and heavy delinquency for those that continue paying. That conclusion now seems inescapable. In other words, yes, they are easy to buy, but impossible to collect.

The amusing part of all of this is that if I live long enough (say another 25 years), most of the people who lived through this meltdown will have passed on. And the new group will disbelieve or ignore what we now know and it will happen again. Depend on it. □

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