GRAINS OF SAND ON THE BEACH

By Martin V. Lavin

Deliveries of HUD Code homes dropped from 373,000 new homes in 1998 to 168,491 in 2002—about a 55 percent decrease. Some believe the bottom of this cycle will be around 150,000 deliveries. In the eyes of most, this constitutes a meltdown. What happened?

While all of the facts aren't in, we do know more than enough to begin to formulate an answer. The simple answer is lending got out of control and loans were made to borrowers unlikely to pay as scheduled. However, it doesn't explain *why* it happened.

Since that day, long ago when the industry first became aware of funding factory-built home loans and selling them to Wall Street investors, it enjoyed a liquidity it had not seen since the early '70s and perhaps more than ever. The industry found in the '90s it could easily sell almost every loan it originated, recover its origination costs, pay itself a generous profit, keep growing rapidly and, in many cases, report record profits. This allowed thinly capitalized companies to keep buying loans, bundling, securitizing and selling them, reliquifying themselves, banking their profits and buying more. More was better. No one wanted to face the realities of declining portfolios and it was so easy.

Loans were being booked quickly, volumes increasing rapidly and new competition coming on frequently. So much so, loans seemed to take on the status of grains of sand on the beach. That is, there was very little to differentiate them. They were all so alike, why spend a lot of time investigating and thinking about them.

Down payments and verifications became nonexistent. They took too much time and effort and made you uncompetitive. If all the loans were the same, who cares about down payments, jobs and verifications? The secret to success was to buy quicker and deeper with longer terms and lower down payments. And we did. As an industry, we were buying, securitizing and selling loan volumes in historical dollar amounts. In unit sales, we enjoyed more success than at any time since 1972-73.

Euphoria prevailed and while there were quietly spoken concerns by many, no one can deny it all seemed to be working. Skeptics were wrong and had been for quite a while. Their frequently cited concerns seemed more like envy than insight. Factory-built home portfolios sold quickly and brought large profits. The compensation of lending executives was *Wall Street Journal* front-page news. The industry had arrived, big time, driven by this new liquidity.

A bump in the road

By 1996-97, some of the new industry lending start-ups were experiencing loan quality hiccups. Even with sound buying by some, servicing needs were challenging and the rapidity of lending growth made proper servicing difficult. They found they couldn't grow their servicing capabilities nearly as quickly as they could buy new loans. Loan sales made money and servicing cost money, or so it was perceived. It also was perceived default levels wouldn't get out of hand and even if they did, our interest rates were high enough to pay for the losses. Obviously, two very wrong assumptions were made.

More than one lender's originations were occurring too quickly for their servicing to handle whether they were sound or not. And once the delinquencies and defaults reached certain levels, their liquidity dried up as portfolio sales slowed.

Portfolios were sold at a loss, exit strategies were formulated and the industry buzz was directed toward the inability of a failing or struggling lender to rise to the occasion or that buying was "too loose." Never mind that buying was actually fairly uniform throughout the industry.

The big differences between the early winners and losers were tied to servicing capabilities, reputation and rapidity of portfolio growth. These tended to preserve the momentum for the "successful lenders" even after poor buying practices were rampant and high delinquency and default rates were locked into the originated portfolios. It just took time to manifest, but they were there, waiting to erupt in spite of industry lender denials. By 1998-99, an uneasiness was already swirling in the money markets. Prepayments, due to defaults and other maladies, were being felt in securitized portfolios. Starting as a trend unforeseen by most and then asserting itself at levels beyond expectations, defaults started eroding the stability of the portfolios as investments. Performance started to tumble, defaults accelerated, profitability waned and enthusiasm dimmed. All lenders paid the price, some more than others.

As investors demanded more yield to continue the purchases of factory-built home portfolios, lenders found they were unable to sell their bundled loans as profitably as they had previously. In some cases, they couldn't sell them at all, except at a horrific loss. Earnings were restated by some while lending was contracted by all. Sales plummeted and losses mounted. The process fed on itself and new money became difficult, expensive and, for many, including industry giant Conseco, was not available at all. This spelled doom for them and others with similar problems.

It became obvious factory-built home loans were not like grains of sand on the beach. Even the most resistant lenders had to admit the obvious, but in most cases were too late and found themselves jobless. The old thinking that facts matter and not every borrower can be profitably served was thrust back unwillingly on a resisting industry.

Reality check

The present finds many would-be borrowers denied for loans who would have been approved in the past. The new reality, actually the old reality, was harsh change. After all, you had to admit that in an industry in which 14 to 21 percent of all loans default, over the life of the full line portfolio, even when you do things right, who needs more losses? The interesting fact is how slowly most were to change even when it became obvious the old model wasn't working.

Today, some portfolios are expected to default at a minimum of 30 percent. The true figures won't be known for awhile. The whole industry is decimated as financing affects everyone. The usual suspects are blamed: fraud in loans, low down payments, extended terms, aggressive advances, even sunspot activity. The industry would do well to focus on credit profiles, risk-based pricing and sound servicing as well as the aforementioned suspects. And maybe, just maybe, there are not enough bankable borrowers to support 373,000 HUD Code shipments. This fact seems to have been thrust on lenders and is now staring the rest of the industry face on. The real question now is: What is the true volume of lendable purchases? And more importantly, is there money for that volume?

If we eliminate the peaks of the early 1970s and the late 1990s, the industry has delivered about 245,000 new homes per year over that period. It has done so with volume generally from a low of 170,000 homes to a high of 300,000, varying about 60,000 homes at the top and bottom from the average of 245,000. Is this the normal range? Well, it certainly has some ring to it.

Now we face issues we haven't dealt with for some time. First, with money from Wall Street scarce and expensive, financing is likely to remain tight, potentially for years. So, the liquidity lenders need to succeed has been removed. The loans they originate have to be high quality credits at high interest rates, at a time when those borrowers can easily get into site-built homes with real estate financing. Presently, we are highly non-competitive in that regard. And, the people prepared to buy and pay our interest rates are not high quality borrowers in sufficient numbers for the industry to prosper.

Second, the industry lost all three major national full-line factory-built home lenders (The Associates, GreenTree/Conseco and GreenPoint/BAHS).

Full line lenders loan on chattel and land/home for 600 FICO scores on up. Not all 600s, but about 40 percent of volume will come from 600-649, 40 percent 650-699 and 20 percent above 700. Their portfolios will average between 645-650. With these lenders gone, the remainders, with one vertical-integrated exception, loan only on a limited basis, essentially 650 FICO and up, trying to average around 670-680 FICO.

Obviously, a large number of loans will not be purchased in this scenario, reducing potential volume at least 40 percent. They can't be blamed because if they buy this paper, it can't be resold in today's market. Further, most remaining lenders lack the guerrilla servicing necessary to be a full line factory-built home lender.

Even if a large, liquid lender should enter the fray, how long will it take them to construct and implement a national, full line lending model? Since none really exists to take over in their entirely anymore, it could take years. The previous nationals are disbanded, their employees gone, offices closed, leases cancelled and fax machines quiet. The next national lender will build from scratch. That will take time.

So, as the industry battles the most destructive episode in its history with only the glimpse of an end in sight, recovery still looms far in the horizon, the drop in activity not yet finalized. Absent a renewed and vital financing model, I cannot see any sort of quick recovery.

While factory-built home real estate financing has been a bulwark against a total sales shutdown, it still remains to be shown we have any unique or cost competitive advantages, even after 30 years of trying to best site-builders at their own game. We continue to compete in this arena, but are hardly all-conquering. If this is the great hope, it remains unfulfilled.

All loans are not created equal. It is a shame something everyone should have known had to be learned again. I learned it in 1974-75 and again in 1989-91. But many in the industry had missed those previous episodes or forgot them. Some actually believed factory-built home loans were all the same, just like grains of sand on the beach. And most acted like they were, for a while. ■

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