GIVE YOUR PORTFOLIO AN MRI

A THOROUGH LOOK UNDER THE HOOD OF YOUR PORTFOLIO CAN KEEP YOU FROM REPEATING YOUR BAD DEBT LOSSES OF THE PAST

BY KENNETH B. SHILSON, CPA

BHPH dealers began this year with considerable optimism.

Customer demand for affordable used vehicles was high, interest rates were low, employment was strong and subprime competition was reduced – all reasons for optimism.

Then along came the COVID-19 pandemic in March, spoiling a promising start to the new year.

With that history in the rearview mirror, what should operators do to emerge successfully from the pandemic?

The best answer: Look under the hood of your portfolio now so you don't repeat your bad debt losses tomorrow.

Availability of the capital needed to regain market share will likely constrain future growth for several months. Therefore, operators must generate more internal cash flow and "make more from less."

That means giving your portfolio a thorough review – a financial MRI – to identify what's working best and what isn't working at all.

Simply, operators must learn from their past losses instead of repeating them.

Future success will be determined by "keeping them sold" and customers paying. Cash and cash flow will provide the gas that fuels your operations.

In today's circumstances, operators are encouraged to perform a deep-dive review of their subprime portfolio, which should include:

Static pool and loss/liquidation (the inverse of CRR) calculations, which compute performance statistics tied to the periods of origination. That allows operators to determine whether losses are increasing or decreasing, and identify important trends.

In addition, it's also important to compare the pace of losses between different periods of each year.

If you're not familiar with those metrics, view the videos at www.subanalytics.com for a brief tutorial.

Loss rate analysis should also include gross loss (before recoveries), net loss (after recoveries) and default rate calculations that correlate to their dates of origination.

In this type of analysis, the entire portfolio is segregated by origination intervals (usually monthly) so loss trends can be identified and compared. When your loss metrics are compared with your regional and national peers from our $24 billion database, it puts your own performance in perspective.

Recovery rates must be calculated to ascertain whether yields on repos and other recovery techniques are working successfully.

Improving recovery rates helps mitigate net losses even when default rates remain the same or increase.

Operators must maximize their recovery proceeds in the current environment. That starts by identifying what your average recovery rates are currently.

A comparison should be made of bad debt losses versus deals that performed to identify underwriting differences and areas in which future underwriting, collateral or business model changes are needed.

The comparison should focus on all your business model elements, such as the vehicle cost, sales price, markup, down payment, payment amount, loan term and all other components of each deal.

There are only three key elements to every Buy Here-Pay Here deal: the customer, the vehicle and the deal structure. All three elements are vitally important to repayment success or failure.

In order to maximize profits and cash flow, operators must avoid trial-and-error mistakes, which cost millions of dollars in losses.

Instead, use portfolio analysis to validate the most successful underwriting strategy before additional bad debt losses are incurred.

Some operators believe credit scoring systems are the key to successful underwriting. But credit scoring only assures consistency – not whether current credit decisions will be successful.

Only when credit scores are directly correlated to portfolio loss statistics can the results be accurately validated.

Individual portfolios perform differently and custom credit scoring models are needed to produce predictable results based on your own market data and business model.

That requires a detailed analysis of your existing portfolio performance to identify the important customer attributes to include in the scorecard.

Computerized analysis prepared from a data extract provided by your software provider is the most efficient and cost-effective way to perform all the analysis we've discussed.

The use of data-mining technology enables the analysis to be done without requiring any input or data entry by your personnel.

The cost is minimal and the resulting reduction in losses and increased customer repayments directly improves cash flow and profitability.

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Compiling bad debt losses should be the start of portfolio analysis, not the end.

Without a deeper dive to identify the causes, underwriting mistakes will likely be repeated and the future will be no better than the past.

Those who do not identify and learn from their past mistakes are destined to repeat them.

KENNETH SHILSON, CPA, IS PRESIDENT AND FOUNDER OF THE NATIONAL ALLIANCE OF BUY HERE-PAY HERE DEALERS AND SUBPRIME ANALYTICS, WHICH PROVIDES COMPUTERIZED PORTFOLIO ANALYSIS FOR OPERATORS AND CAPITAL PROVIDERS IN THE SUBPRIME AUTO FINANCE INDUSTRY. FOR MORE INFORMATION, VISIT WWW.SUBANALYTICS.COM OR CALL (832) 767-4759.