



# Financial Sense

## Rein in Bad Debt, Improve Cash Flow

By Stephen Lefkovits

**A**ccording to ACA International, the leading trade association representing credit and collections professionals, just 18 percent of all money referred to collections agencies is eventually recovered, leaving multifamily owners and management firms holding the proverbial bag—bad debt.

Security deposit alternatives, which provide the multifamily owner with at least as much as, and often better, coverage than a traditional security deposit, have become a powerful tool in fighting bad debt associated with lost rent or property damages.

First introduced in the late 1990s, security deposit alternatives, most often found today in the form of a surety bond, back up the resident's promise to the property owner to leave the property in rentable condition. The surety bond also provides that 100 percent of the money owed by the resident will be paid up to the bond amount.

### Bottom-Line Benefits

Here is how the program works: At lease signing, the resident chooses between paying the traditional security deposit directly to the property owner, or he or she can pay a one-time, non-refundable bond premium to the surety. If the resident selects the security deposit alternative, the bond covers the lifetime of his or her residency at that property, in particular, as well as at other properties within the owner's portfolio that offer the program without having the resident incur additional expenses. If any covered damages or lease violations occur, owners file a claim for

reimbursement within 30 days, subject to the availability of funds.

The benefits of security deposit alternatives to owners can be substantial. The security deposit alternative discourages renters from failing to pay their rent or leaving their units in poor condition when they move out. This is because the renter remains fully liable for his lease obligations under the terms of the surety bond. In addition, the resident's lower upfront costs required to move into a new apartment make it easier for a leasing agent to close the sale.

The leasing agent must make it clear to the resident at lease signing that the security deposit alternative is not a no-fault insurance policy that allows him or her to walk away from his or her obligations at move-out.

"Laying out less cash is the big selling point [for security deposit alternatives]," says Linda Willey, director of property services at Camden Property Trust. "Moving is a time when people incur lots of expenses. Reducing the out-of-pocket costs helps provide a break when things are tight for a renter and helps the leasing consultant to close."

But arguably, the most dramatic benefit to owners can be found in their enhanced level of protection and the subsequent and significant impact on a property's bottom-line.

One large portfolio owner, for example, who offers residents a security deposit alternative at lease signing, says the program has enabled it to recover an additional \$263,000 since December 2002, or \$314 more per claim, than they would have without the security deposit alternative. To date, the firm has filed 838 claims and has collected \$389,000 from their surety bond premium pools. By their estimate, before joining the program, their security deposits averaged \$150. This would have provided just \$125,700 to cover those 838 claims.

Furthermore, this significantly improved financial protection and costs property owners nothing, because bond premiums are paid by residents. The claims process typically associated with security deposit alternatives is superior to the old collections methods. The speed with which claims are reimbursed and the lessened administrative burden are the most cited benefits among those that



### QUICK TIP

Security deposit alternatives differ from traditional security deposits in several important ways:

1. Providers of security deposit alternatives pool resident premiums, which provides property owners with a higher level of payment assurance than a single security deposit of a lesser amount.

2. By handling the collections, the security deposit alternative provider offers a more efficient and reliable solution to recover damages by freeing up apartment firms' time and corporate resources typically associated with traditional security deposits.

3. With security deposit alternatives, the surety promptly pays 100 percent of an owner's claim, which means account receivables do not age past 30 days. However, with traditional security deposits, where the responsibility for collections falls to the owner, the owner can expect to recover only 18 percent of the debt on average, and over a considerably longer period of time than 30 days. At the end of the day, the owner must account for the loss for the remaining 82 percent that will never be recovered through collections.

4. Security deposit alternatives require a significantly lower initial cash outlay than traditional security deposits, even though the surety bond premium is non-refundable. For example, instead of paying \$500 for a traditional security deposit, a renter may pay only \$87.50 for \$500 worth of coverage for the owner. In communities where residents are offered a choice between a security deposit alternative and a traditional security deposit, as many as 90 percent of prospective residents opt for the former.



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offer the alternatives to residents. Some multifamily companies report that their security deposit alternative program saves them two or more hours per file to dispose of a case.

“The security deposit alternative made the process a little more clean-cut,” says Mark D. Gluskin, CFO of Sherman Residential. “As soon as there’s a move out [with losses that Sherman can’t collect], we refer cases to [the surety].”

## Managing Claims

The importance of properly educating on-site leasing staff about the nature and purpose of the program is key to the success of the security deposit alternative program that pools premiums to pay future claims. Specifically, it’s important to understand that the claims pool is not insurance and that it is not an acceptable shortcut to allow a quick lease-up with unqualified residents. It also is important to understand that the security deposit alternative is not intended or designed to provide loss coverage for residents who are rejected by the property’s credit screening system.

Total loss coverage available to the owner is capped by contractually stipulated amounts. And the owner who, for example, bypasses screening standards will quickly bump up against the cap. Therefore, poor implementation can expose an owner to even greater risks than would have been the case with traditional, cash security deposits. Similarly, if an owner relies on the claims pool as a kind of “slush” fund and files claims indiscriminately to cover the smallest damages, or even questionable claims, the owner risks reaching his claims payment cap.

Many of the most forward-thinking multifamily companies rely on the standardized claims process offered by security deposit alternative program providers, as well as the regular reporting features they offer, as management tools to track losses and examine comparative claims data. As a result, on-site management may be more accountable in regards to the claims they file with the provider.

In fact, there is a correlation between on-site management’s accurate reporting of losses and the assurance that a community’s or portfolio’s claims pool will have adequate resources to pay future claims, a

critical element for the owner/manager’s successful deployment of the security deposit alternative program over the long term. Leveraged properly, security deposit alternatives can deliver on the promise of healthier balance sheets. [PRO](#)

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