The Changing Landscape of Indirect Automobile Lending

Many traditional aspects of indirect auto lending have changed owing to significant competitive pressures exerted by the captive finance companies (captives) of automobile manufacturers. In response, many banks have loosened underwriting standards and relaxed procedures to become more "borrower friendly" to compete with the financial concessions of competitors. As a result, some banks operating in this highly competitive market with weak controls and lax automobile loan underwriting programs have been adversely affected. Banks with stronger programs remain susceptible to diminishing collateral values as loan terms continue to be extended over longer periods.

Traditionally, Federal regulatory agencies and bank internal loan review departments have relied on a delinquency-based approach to evaluate automobile loan portfolios. This approach has served regulators and bankers well, but recent automobile financing trends may require a more in-depth analysis when loan and collateral values are not correlated, vehicles are financed multiple times, or losses are deferred and embedded in loan balances.

This article discusses how heightened competition, weak underwriting standards, and lax auto lending controls can harm a bank's asset quality, earnings, and capital. Two case studies identify warning signs and highlight best practices that will strengthen automobile lending programs. Consumer compliance risks associated with indirect auto lending are considered, along with controls to mitigate those risks.

Trends in Indirect Auto Lending Structure

Banks develop indirect automobile lending programs by establishing relationships with automobile dealers. Insured financial institutions define the type of borrower and loan they will accept by providing dealers with underwriting and interest rate guidelines. In most cases, a dealership's finance manager gathers credit information from prospective buyers, completes loan applications, and forwards the documents to the bank for approval. Historically, auto financing has been perceived as a low-risk form of lending, with risk spread among a large volume of small-balance, collateralized loans. However, recent instances of weak indirect auto lending programs have indicated insufficient collateral values and marginal to deficient borrower repayment capacity, resulting in substantial financial adversity for the lender.

Anecdotal evidence suggests that increased competition is influencing indirect auto lending programs. Heightened competition has prompted banks to offer lower interest rates, lengthen amortization periods, and scale down payment requirements. In some cases, competition has prompted banks to grant lending authority to the dealer in order to expedite the approval process for loans that fall within bank-approved guidelines. Banks sometimes permit credit arrangements outside underwriting guidelines if the dealer signs a recourse agreement stating that it will repurchase such loans if they become delinquent. Recourse agreements vary, and some expire after a certain period of time has passed or a certain number of payments have been made. Today's indirect automobile lending practices represent unique challenges to bank management and supervisors.

Automobile Finance Market Conditions

In recent years, automobile manufacturers have responded to overproduction by offering special rebate and financing offers to stimulate consumer demand. The manufacturers' primary objective is

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to reduce inventory; pricing and financing are secondary concerns. This goal conflicts with that of other lenders, whose primary goal is to earn a fair return for a limited amount of risk. Manufacturers use their captives to introduce special financing offers. Captives, such as General Motors Acceptance Corporation, Ford Motor Credit, and Toyota Motor Credit, dominate the industry, with 56 percent of the automobile financing market in 2003.[1] Banks, credit unions, and other finance companies comprise the remaining market.

To spur demand, manufacturers have introduced large cash-back rebates, while their captives offered zero- and low-rate, no-money-down financing for longer periods. The Consumer Bankers Association's (CBA) 2004 Automobile Finance Study reflects an annual increase of 6 percent for the average automobile loan balance, while the average amount financed grew to represent 99 percent of invoice for new cars and 96 percent of wholesale value for used cars. To compensate for the larger loan balances, loan amortization periods have lengthened to keep monthly payments low and vehicles affordable. Federal Reserve Bank data show the average new car loan maturity increasing from 53 months to 62.5 months between 1999 and fourth quarter 2003 as more consumers selected a 72-month loan product. An article in the American Banker indicates that the terms of automobile loans are increasing, with some banks offering eight-year loans.[2]

Initial vehicle depreciation rates generally exceed loan amortization rates for credits with lengthy amortization periods. Increased loan balances, low down payment requirements, and lengthy amortization periods create negative equity, a situation in which the loan balance exceeds the vehicle's value. J.D. Power and Associates estimates that approximately 38 percent of new car buyers have negative equity at trade-in, compared to 25 percent two years ago.[3]

Impact on the Banking Industry

Vehicle financing trends reflect a general weakening in overall underwriting standards, leaving automobile loan portfolios increasingly vulnerable to an economic downturn. To date, weaker loan underwriting has not translated into widespread asset quality problems in the banking industry. The relatively low interest rate environment and a healthy economy have contributed to improved automobile loan loss and delinquency rates. According to a Moody's report, the October 2004 auto loan net loss rate fell from 1.22 percent in October 2003 to 0.93 percent in October 2004, and account balances more than 60 days late declined from 0.56 percent to 0.46 percent.[4] The Moody's report also indicated that the net loss rate and delinquency rate had fallen for 17 and 18 consecutive months, respectively, on a year-over-year basis. These positive industry trends reflect the strengthening U.S. economy. However, these trends may mask the actual risk inherent in automobile loan portfolios. The 2004 CBA Automobile Finance Study states that the average net loss per unit increased 10 percent since the prior year, a statistic that may suggest more borrower-friendly underwriting standards at the same time the incidence of negative equity value of collateral is on the rise. The case studies in this article reflect the impact these high charge-off rates can have on an

[1] Deutsche Bank, "U.S. Autos: A Triple Threat," February 20, 2004.

[2] "Driven into Making More Used-Car Loans," *American Banker,* April 15, 2005.

[3] "Owing More on an Auto Than It's Worth as a Trade-In," *New York Times,* March 27, 2004.

[4] Moody's Reports: Prime Auto Net Loss and Delinquency Rates Continue to Improve in October 2004.

institution's capital and earnings, following loan defaults. Rising market interest rates or a general economic downturn could affect marginal borrowers' repayment capacities and may eventually subject the banking industry to increasing losses.

Large cash-back incentives depress used car values, resulting in lower repossession values. At the same time, favorable consumer financing terms may heighten risk and shrink profitability. It has become more difficult for banks to compete safely in a market dominated by captives, which establish lending criteria that are influenced by manufacturing decisions rather than the risk/return trade-off of each financial transaction. In some cases, banks' attempts to remain competitive with captives have resulted in portfolios characterized by lower interest rates, extended loan amortization periods, and weaker borrowers. These underwriting trends suggest that some banks' automobile loan portfolios may require closer internal review and regulatory scrutiny.

Regulatory and Industry Approach to Retail Credit

To evaluate a large volume of small-balance loans efficiently and consistently, the FDIC, the Comptroller of the Currency, the Federal Reserve Board, and the Office of Thrift Supervision adopted the *Uniform Retail Credit Classification and Account Management Policy.*[5] The policy provides general guidance for assessing and adversely classifying retail credit based on delinquency status. Auto loans, considered closed-end credit, that are delinquent for 90 cumulative days are classified Substandard; those at least 120 days delinquent are classified Loss. Examiners are charged with ensuring that banks adhere to this policy, unless repayment will occur regardless of repayment status. Many internal loan reviews have adopted a similar approach. Traditional application of this approach assumes that borrowers initially had adequate repayment capacities or that the collateral values cover loan balances. Closer scrutiny is required when auto loan portfolios have not been underwritten in a traditional fashion. Examiners have the latitude to deviate from the prescribed classification guidelines when historical delinquency and charge-off trends warrant such action. In cases where underwriting standards are weak and present unreasonable credit risk, examiners may also classify entire portfolios or portfolio segments. Similarly, bank management should consider a more in-depth transaction-based review if traditional formulas are not capturing insufficient collateral values or the performance of less financially substantial borrowers.

Case Studies: When Indirect Auto Lending Went Awry

A number of banks have developed heightened risk profiles while attempting to maintain or increase market share in automobile financing. These case studies show the pitfalls banks may face when they compete in this market without appropriate lending policies, procedures, internal controls, and oversight.

Bank A

Bank A opened in the second quarter of Year 1 with an indirect automobile lending program managed by one loan officer. By the end of Year 2, indirect automobile loans represented 58 percent of total assets and 370 percent of Tier 1 capital; the delinquency rate was relatively low at 1.91 percent. Bank A also reported a 0.30 percent return on assets, despite its relatively small size and recent

[5]Federal Financial Institutions Examination Council, Uniform Retail Credit Classification and Account Management Policy, 65 Fed. Reg. 36903 (June 12, 2000).

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start-up date. Bank A's management attributed early profitability to the indirect automobile loan portfolio's success. However, by the end of Year 3, the bank reported a net loss owing to charge-offs and provisions to the allowance for loan and lease losses (ALLL). In Years 4 and 5, delinquencies, charge-offs, added provisions to the ALLL, and losses from the sale of automobile loans significantly depleted capital. Automobile lending was a part of the bank's strategic plan, but not to the degree depicted in Table 1.

Although the loan policy included a maximum 110 percent loan-to-value ratio, minimum 640 credit score developed by Fair Isaac & Company (FICO), and maximum 60-month maturity limit, the loan officer consistently approved credits outside these guidelines. Examiners also determined that dealer reserves were not properly monitored. The difference between the bank's "buy rate" and the interest rate charged on the loan at the dealership was placed into a dealer reserve and was intended to be distributed to the dealer over the life of each loan. However, in many cases reserves were made available to the dealer after the vehicle had been repossessed. Lack of oversight allowed these loan policy contraventions to occur, and the loan officer was compensated with bonuses tied to the volume of indirect dealer paper generated. Following a random sample of automobile loans, examiners determined that subprime loans comprised 78 percent of the portfolio, and most originated from a single dealership. The board of directors was not aware that the loan policy standards were ignored nor that the bank had developed a subprime loan portfolio.

Inadequate oversight and controls also permitted the loan officer to manipulate delinquency and net loan loss figures through a perverse repossession cycle. Bank A's loan officer and president waived dealer recourse without board approval on several loans in return for the dealership's agreement to store all repossessions at no charge and sell the repossessions for a small commission. During this cycle, the dealer sold repossessions at prices well above market value to borrowers with extremely low FICO scores. In most cases, these sales included thousands of dollars in add-ons (credit life insurance, extended warranties, and Guaranteed Auto Protection insurance) for which the dealer was paid immediately through bank financing. The bank reported a gain on the sale of repossessions, assumed excessive credit risk on bank-financed repossessions, and, for a few months, essentially understated the level of losses and nonperforming assets (i.e., the relatively low 2.86 percent delinquency ratio at the end of Year 3).

Table 1

Statistical Trends in Bank A

Key Risk Indicators	Year 1	Year 2	Year 3	Year 4	Year 5
IL/ Total Assets	38.03%	58.39%	44.03%	36.38%	9.00%
IL / Total Capital	147.32%	369.94%	428.71%	1,024.73%	121.55%
% Delinquent IL	0.00%	1.91%	2.86%	20.62%	29.28%
Gross Charge-Offs	0	$12M	$290M	$1,328M	$2,547M
ALLL Provisions	$79M	$130M	$545M	$3,984M	$0
Net Income	($673M)	$110M	($414M)	($4,112M)	($822M)
Total Equity Capital	$6,687M	$6,703M	$6,412M	$2,208M	$1,731M

Note: ALLL = allowance for loan and lease losses; IL = individual loans; M = thousands.

Transaction testing enabled examiners to identify lending practices that deviated significantly from board-approved policies. This finding prompted an extensive credit file review in which examiners found numerous vehicles financed three and four times without documentation to demonstrate sufficient repayment capacity or collateral for these loans. The average bank-financed repossession reflected a 186 percent loan-to-value ratio and a 554 FICO score. Bank A recognized multiple charge-offs on the same vehicles, which likely exceeded the losses that would have been recognized had the bank sold the initial repossessions on a wholesale basis (see Table 2).

Owing to the speed of deterioration in Bank A's auto loan portfolio, examiners conducted migration analyses to establish accurate adverse classification and ALLL levels. Examiners separated bank-financed repossessions from the other auto loans because of their distinctly different default rates. Results from the migration analyses indicated that 29 percent of all bank-financed repossessions deteriorated to a Loss category (repossession or 120 days or more delinquent). More specifically, the bank-financed repossession analysis reflected that 15 percent of current loans, 38 percent of loans delinquent between 30 and 89 days, and 100 percent of loans delinquent between 90 and 119 days migrated to a Loss category. Actual loss history reflected that the bank charged off 41.5 percent of each bank-financed repossession loan balance. The migration analysis on the remaining consumer loan portfolio indicated that 1.31 percent of current loans, 25 percent of loans delinquent between 30 and 89 days, and 80 percent of loans delinquent between 90 and 119 days migrated to a Loss category. The bank's loss history for the remaining indirect auto credits reflected that 25 percent of each loan was charged off upon repossession.

Results from the migration analyses indicated that the formula classifications in the *Uniform Credit Classification and Account Management Policy* guidelines would not accurately reflect the risk in Bank A's auto loans. Examiners used the migration analyses to establish more accurate adverse classification totals that required significant ALLL augmentation. By the time problems were identified and brought to the board of directors' attention, the bank required a significant capital injection to remain viable. Unsuccessful efforts to recapitalize the bank ultimately led to the bank's acquisition by another institution. Shareholders of Bank A never fully recovered their initial investment. Regulators issued various enforcement actions, including a civil money penalty and prohibition against the loan officer from participating in the affairs of any insured financial institution.

Table 2

Examples of Bank A's Bank-Financed Repossessions

Loan Balance	Automobile	NADA Value	Loan-to-Value
$21,412	Vehicle A	$8,250	259%
$18,398	Vehicle B	$8,250	223%
$20,570	Vehicle C	$9,900	208%
$12,469	Vehicle D	$8,800	142%
$20,394	Vehicle E	$7,225	282%
$21,272	Vehicle F	$9,900	215%

Note: NADA = National Automobile Dealers Association.

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Bank B

Bank B is a midsized, well-established bank with experience in indirect automobile lending. Auto loan delinquencies were consistently high, but supervisory concern over delinquencies was mitigated by reported losses that were not extraordinarily high. For a number of years, the bank's indirect automobile loan portfolio ranged between 4 percent and 9 percent of total assets. Despite a moderate portfolio, these loans represented a relatively large portion of Tier 1 capital, ranging from 70 percent to 123 percent between Year 1 and Year 5. Although delinquencies exceeded 10 percent of total indirect automobile loans, the ratio remained relatively constant, and Bank B consistently reported a mediocre return on assets. However, the examiners' file review in Year 5 highlighted a number of problems that resulted in large loan losses, increased provisions to the ALLL, and a declining Tier 1 capital ratio (see Table 3).

Results of examiner transaction testing showed that indirect automobile loans were approved by one officer, and most originated from a single dealership. Many of the indirect automobile loans were to subprime borrowers and were approved with insufficient documentation. In addition, the officer routinely approved credits in excess of 100 percent loan-to-value. As a result, the bank developed a portfolio of high loan-to-value, subprime loans. The problems were compounded by a repossession cycle that included bank-financed repossessions. In several cases, dealer recourse was waived without reason. In other cases, problem loans were rewritten with past-due interest, repairs, and add-on expenses (Guaranteed Auto Protection insurance, extended warranties, and/or credit life insurance) capitalized and added to the bank's exposure.

These accounting and lending practices resulted in understated delinquencies and losses, which prevented a full and timely recognition of the problems. Lax underwriting and excessive loan-to-value ratios contributed to charge-offs that represented approximately 20 percent of the average auto loan portfolio between Year 1 and Year 5. Bank B did not possess sufficient information technology for examiners or bank management to perform a meaningful migration analysis. Bank B continues to struggle to recover from the adverse effects of the indirect automobile lending program.

Lessons Learned

Competition for automobile finance products is intense, requiring vigilance from bankers and regulators when portfolios are significant in relation to a bank's capital and earnings. The problems associated with Banks A and B were identified only after examiners performed transac-

Table 3

Statistical Trends in Bank B

Key Risk Indicators	Year 1	Year 2	Year 3	Year 4	Year 5
IL / Total Assets	8.63%	8.53%	7.80%	5.55%	4.42%
IL / Total Capital	122.72%	107.83%	95.59%	84.99%	70.37%
Delinquent IL	10.51%	10.45%	10.51%	10.33%	11.89%
Tier 1 Capital	8.12%	7.92%	7.86%	5.93%	5.50%
Gross Charge-Offs	$304M	$358M	$534M	$333M	$2,157M
ALLL Provisions	$350M	$350M	$519M	$250M	$2,768M

Note: ALLL = allowance for loan and lease losses; IL = individual loans; M = thousands.

tion testing and reviewed credit files. These case studies show that automobile lending is not the conventional collateral-based product it was in the past, but now places increased emphasis on borrowers' repayment capacity, timely internal identification of potential problem loans, and closely monitored underwriting policies that prevent undesirable loans from being extended. The basic tenet of strong oversight is a comprehensive automobile lending policy. Examiners must determine bank management's tolerance for risk and validate that underwriting practices comply with policy guidelines. Examiners and bank management should monitor and address any deviations from approved policies, watch for spikes in portfolio growth or delinquency levels, and ensure that adequate independent loan reviews and audits are performed. Lessons learned from the case studies indicate that the following steps should be taken to provide effective regulatory and bank management oversight:

Compare auto lending trends to strategic plans for consistency, including growth rates, risk levels, and anticipated rates of return on that risk.

Ensure automobile lending policies establish specific underwriting guidelines that encompass credit scores, debt-to-income ratios, interest rates, amortization periods, loan-to-value ratios, diversification standards, and concentration limits (from a single dealer).

Determine that the control structure provides sufficient oversight in the lending decision process.

Verify that auto loans are adequately covered in independent loan reviews and scopes of internal/external audits.

Ensure collection procedures and the repossession process are independent of any bank personnel involved in originating that credit.

Verify that potential loss evaluation methods have some relation to the behavior of the portfolio.

Validate that lending practices conform to approved policies through a sampling of files if the auto loan portfolio is significant in relation to capital.

Ensure bank-financed repossessions are identified and tracked.

Determine whether management has waived any dealer recourse agreements.

Verify that information technology systems are used effectively to create a database capable of capturing a number of variables (credit scores, dealers originating the paper, debt-coverage ratios, bank-financed repossessions, and vehicle identification numbers).

Compliance Considerations of Indirect Auto Lending Programs

Indirect automobile lending can also expose insured institutions to compliance risks, particularly related to fair lending and unfair and deceptive practices. It is critical to determine whether a bank is considered a creditor and whether an agency relationship exists with the dealer. A "creditor" is defined by Section 202.2(l) of Regulation B.[6] There can be multiple creditors in a single credit transaction. In indirect automobile lending there are usually at least two: the bank and the dealer.

[6] 12 C.F.R. Section 202.2(l) (2005). See also 12 C.F.R. Part 202, Supplement I, Official Staff Interpretation for Regulation B, 2(l): "The term creditor includes all persons participating in the credit decision. This may include an assignee or a potential purchaser of the obligation who influences the credit decision by indicating whether or not it will purchase the obligation if the transaction is consummated."

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A bank buying dealer paper (i.e., loans that have already been made) that did not influence and was not involved in the credit decision in any manner is not considered a creditor under Regulation B. However, a bank that either influenced or was involved in the credit decision is considered a creditor and is subject to all fair lending regulations. It is also essential to determine the nature of the relationship between a bank and an auto dealer. Banks are directly responsible for any discriminatory pricing or other discriminatory decisions made by a dealer acting as an agent of the bank.

If no agency relationship exists, a bank could still be responsible for a dealer's discriminatory practices if it continued to participate in the transactions from the time it either "knew" or "should have known" about the discrimination. Indications that a bank "knew" could come from internal memos, internal or external audits, internal compliance reviews, or statements by bank employees. Indications that a bank "should have known" would normally consist of *either* (1) a pattern of discrimination obvious enough that a reasonable person knowledgeable about fair lending laws would have realized what was going on even without looking for it, *or* (2) a pattern of discrimination obvious enough that a reasonable person knowledgeable about fair lending laws would have realized what was going on if he or she looked for it, *and* there is documentation that the bank looked for it. Banks that play a role in the credit decision process should also ensure that borrowers receive all appropriate disclosures.

Insured institutions also should monitor auto lending programs for any evidence of unfair or deceptive conduct. Such conduct may arise through sales practices as well as through the financing and repossession process. Circumstances that raise red flags in this area include Bank A's practice of financing vehicles in amounts that exceeded their market values and programs that evidence a large volume of first payment defaults (i.e., programs in which a significant number of borrowers walk away from transactions when they begin to appreciate what is truly involved).

Compliance examiners and officers should follow up on any concerns raised during the safety and soundness examination process—for example, if an institution's practices do not adhere to established policies. Issues relating to internal control weaknesses, lack of segregation of duties, and loans made outside approved policies could prompt an expanded review into compliance-related areas.

Conclusion

Competition in the automobile lending market, driven by captive finance companies, has increased significantly in recent years and is not expected to diminish in the near term. The results are thinning collateral and smaller net interest margins. The potential for heightened risk to insured institutions in the compliance and safety and soundness areas can be mitigated only through prudent lending policies and procedures, adequate internal controls, and strong oversight.

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