Indirect auto lending at the crossroads
Strategic implications of the CFPB’s guidance on indirect auto lending and Equal Credit Opportunity Act compliance
While auto lending remained largely outside the purview of many new regulations issued in response to the financial turmoil that occurred in the banking sector, auto finance may be attracting more regulatory attention as auto finance origination volumes rise amid declining home-equity loan volumes, a traditional alternative to auto loans for many borrowers. The auto finance landscape may significantly change due to the recent release of the Consumer Financial Protection Bureau’s (CFPB’s) bulletin signaling its intent to become more involved in auto lending.

The CFPB’s guidance outlining its intention to hold lenders accountable for dealers’ actions related to compliance with Equal Credit Opportunity Act (ECOA) fair lending regulations may be particularly challenging for nonbank lenders who may not have experience in implementing regulatory mandates within consumer business lines.

Indirect auto lenders face a strategic choice in how they will respond to this guidance – they can adapt long-standing dealer-reserve programs to address heightened compliance requirements or they can create alternative products offering dealers flat-fee payments with rates that cannot be marked up (i.e., nonreserve products).

Either strategic alternative carries operational implications that lenders should consider as they formulate their responses to this potentially disruptive change. The mortgage industry’s adjustment to regulation provides an object lesson for auto lenders: regardless of the strategy chosen, efficiently and effectively assimilating regulatory change in a proactive versus reactive manner could potentially provide a powerful competitive advantage. Doing so may allow the lender to focus on serving its market faster, rather than focusing on continual cycles of internal change management.
The tipping point
Recently, the CFPB expanded its focus from mortgage and credit card lenders to other lending segments like student and auto lending. As demonstrated in the mortgage industry, the CFPB has significantly impacted lenders by setting new standards and requirements designed to increase consumers’ awareness and knowledge of financing agreements. These standards typically carry rigid implementation dates and specific requirements for a wide variety of processes and systems, which demand a rigorous implementation methodology.

With the release of the bulletin, *Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act*, the CFPB has deemed auto lenders responsible for ECOA noncompliance even as a result of dealer practices—particularly as related to dealers marking up lenders’ buy rates. The CFPB’s position is that the manner in which the rates are applied creates discretion and significant risk that the final customer rate may not comply with the ECOA. The CFPB has positioned the lender to be wholly responsible and accountable for the impact of the final rates negotiated between the dealer and the end-customer.

The CFPB guidance likely will pressure auto lenders to create or enhance their ability to monitor and demonstrate ECOA compliance or abandon the traditional business model in which dealers earn a considerable portion of their finance and insurance (F&I) income by marking up a lender’s buy rate.

The payoff for effectively implementing strengthened ECOA compliance is potentially huge—lenders retaining the ability to offer reserve payments when competitors cannot could enjoy a critical competitive advantage. However, the ability to comply with the CFPB’s guidance will likely require the creation of new compliance tools and processes with little guidance presently available from the CFPB on specific analytic techniques or additional compliance requirements.

Alternatively, the adoption of a nonreserve program may be significantly easier to implement and could reduce compliance risk, while capitalizing on current trends away from reliance on dealer reserve as a source of F&I income. Lenders who choose this strategy should be prepared to address the need for expanded pricing and marketing skillsets and the changes required within many operational processes and platforms to support these new products.

Strategic alternatives
As the CFPB’s guidance for indirect auto lenders matures, lenders face alternative responses that strike at the core of their retail financing business models. They may comply with the CFPB requirements while designing processes to monitor and control the manner in which their dealers earn reserve, or they can choose to go to market with new, flat-fee based programs. Despite the potential competitive advantages of retaining a reserve-based program, nonreserve products may have a place in the coming auto finance landscape—either as alternatives to reserve-based products, interim offerings, or as second-tier programs for dealers who represent unacceptable ECOA risks within a reserve-based program.

Developing nonreserve products
Currently, many lenders offer some form of nonreserve payments to dealers. Such payments usually take the form of uniform flat fees paid for lease contracts, contracts originated under subvention programs, or contracts in which the contract rate equals the buy rate. Traditionally, these types of flat-fee payments were designed to compensate dealers for their origination costs, but did not significantly contribute to a dealer’s F&I income.

Enhancing nonreserve products may offer an alternative approach for lenders who choose to avoid the risks associated with increased ECOA monitoring in a reserve-based program and may also provide a complementary option in tandem with enhanced reserve-based programs. With their simplicity and straightforward, lower-cost administration, nonreserve programs may also be advantageous for auto lenders.

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Implementing a nonreserve program may require the lender to create a set of rates that could not be marked up, thus becoming de facto end-customer rates. Of course, these rates could vary by term, collateral type and/or risk tier, but the main objective would be to remove dealer discretion in defining the customer rate.

Potential features of nonreserve, flat-fee programs could include:

- Use of stair-step fee structures in which flat-fees might increase as contract volumes rise
- Differentiated fees for new and used vehicles that outline contract terms or risk levels aligned to margins and borrowing costs and drive volume in desired segments
- Nonmonetary awards, such as trips for top volume dealers, etc.

Lenders electing to create nonreserve programs may face several challenges. Many lenders, especially nonbank lenders with little direct lending experience, may need to develop and adapt their pricing methodologies to reflect direct-to-customer pricing drivers. Similarly, this change may require additional end-customer research and marketing, in addition to traditional dealer-channel marketing. As changes directed at end-customers are planned, lenders should assess how these changes may impact, or be perceived to impact, state indirect lending charters.

Perhaps the biggest challenge faced by lenders electing to pursue a nonreserve product is likely to be competing with the income dealers earn on today’s reserve-based products. Some dealers have started to adapt their business models to reduce dependency on dealer reserve income and are becoming increasingly comfortable with a flat-fee system, provided it yields finance income comparable to typical reserve mark up. However, a lender that can retain a reserve-based product may be able to claim a significant competitive advantage, since it could offer many dealers more upside income potential and maintain a long standing F&I paradigm.

Enhancing reserve-based products

Adapting existing indirect auto finance products to incorporate controls to address CFPB’s guidance offers lenders marketing, dealer-acceptance, and operational advantages. However this approach carries significant compliance risk.

Future reserve-based programs likely will need to demonstrate a broad capacity to promptly and efficiently detect and mitigate adverse impacts at a dealer level. Since race, gender, and ethnicity data are not captured in the loan application process, this monitoring capability would probably have to use statistical proxies to detect possible disparate treatment. Some lenders report using geocoding and census tract data, plus surname identification, as a proxy for borrower protected class data. This is likely similar to the process the CFPB used in its analysis – the extent to which a lender’s modeling methodology mirrors the CFPB’s could improve confidence in its outcomes. Unfortunately, the CFPB has not yet released the details of its analysis, forcing lenders to design disparate impact modeling from scratch.

Other modifications to existing retail financing products could include:

- The development of a feedback and corrective action policy for dealers
- The creation of a remediation policy for adversely impacted customers
- The development of a possible flat-fee “spillover” product for dealers that have not satisfactorily performed in a reserve-based program

Pursuing either strategic alternative may require lenders to develop new operational processes, strengthen existing controls, and revisit the performance of certain existing operational areas.

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2 Source: Automotive News, April 3, 2013, “Worried about the CFPB? You should be”
3 Source: Automotive News, June 2013, F&I Week Presentation
Potential operational impacts and implications

The emergence of nonreserve retail financing programs and the possibility of adapting reserve-based programs to meet CFPB guidelines is likely to impact sales, originations, compliance, and pricing processes.

Major operational impacts

Will new products impact key operational areas?

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<thead>
<tr>
<th>Major operational impacts</th>
<th>Non-reserve</th>
<th>Enhanced reserve</th>
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<tr>
<td>Create/modify sales processes</td>
<td>Yes</td>
<td>If needed</td>
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<tr>
<td>Examine origination policies</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Assess service delivery quality</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Build disparate impact modeling/monitoring</td>
<td>NA</td>
<td>Yes</td>
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<tr>
<td>Strengthen fair lending controls</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Develop pricing and profitability capabilities</td>
<td>Yes</td>
<td>If needed</td>
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Depending on the strategic alternative chosen, lenders should be prepared to implement, update, or reinforce their operational platforms and processes in several areas:

Create/modify sales processes
Implementing a nonreserve program may require the development of new sales tools and training for sales staff. For example, enabling sales representatives to easily model a dealer’s F&I income under a flat-fee structure using historical sales data, then comparing it to the dealer’s actual income could enhance fact-based sales conversations. Expanding this capability with interactive online or mobile tools could further enhance the ability for dealers to model “what if” scenarios.

Similarly, lenders pursuing an enhanced reserve product may need to revisit their dealer sales materials to capture program changes and to communicate new processes for monitoring disparate impact.

Examine origination policies
As competition intensifies and new products emerge, dealers could place even greater emphasis on origination policies in what may become a less disparate pricing environment. Examples of critical core origination policies include overall purchase policy and risk appetite, loan-to-value (LTV) policy, and funding exception policies. Policies regarding the ability to finance add-on insurance products (e.g., warranties, credit insurance, etc.) are likely to move to the forefront of dealers’ minds as they increasingly look for ways to build nonreserve F&I income by selling more and different kinds of these insurance products, which have also attracted the CFPB’s scrutiny.5

Assess service delivery quality
Regardless of the strategy pursued, a lender may face a much more dynamic market as new, nonreserve programs emerge and as lenders change their reserve-based programs. The result could be a renewed emphasis on many service delivery quality attributes that have largely become “table stakes” in recent years. For example, maintaining or improving decision turn times, once a clear driver of lender capture rate, may reemerge as a headline metric as lenders and dealers alike adapt to new products and processes. Similarly, lenders will likely need to closely monitor funding turn times and provide quick funding with thoughtful funding exception policies.

Lenders should also analyze the state of broader measures of dealer satisfaction to help them manage the launch of new products and the emergence of new competitive programs. Dealer service satisfaction surveys should be updated to specifically address satisfaction related to new products and launch processes. Such analysis and feedback provide an opportunity to assess the overall strength of dealer relationships and to invest in building and maintaining profitable ones – while the lending industry adjusts to the new environment.

Build disparate impact modeling/monitoring
Building, testing, administering, and validating a disparate impact model is likely to be the cornerstone of developing a compliant reserve-based program. This type of model could go beyond traditional ECOA processes to apply proxies for customer characteristics (e.g., race, gender, ethnicity, etc.) and monitor results at a dealer/dealer-group level in near real-time.

In addition to the model, lenders choosing this strategic alternative should consider developing documented processes for executing the model, analyzing results, acting on adverse results, and remediating impacted customers.

5 See Consumer Financial Protection Bureau press release “CFPB orders auto lenders to refund approximately $6.5 million to servicemembers” dated June 27, 2013.
As part of a broader dealer feedback cycle, these processes could include documented progressive discipline for dealers in which a disparate impact has been observed. An effective feedback process is also likely to add to a lender’s value proposition by providing the dealer with a meaningful way to assess and detect adverse impact, in addition to meeting the lender’s control requirements.

Finally, this control process should enable the results of the analysis to be clearly illustrated for regulators, even at an individual account level.

**Strengthen fair lending controls**

Regardless of the strategic option chosen, lenders should invest in assessing and improving their overall ECOA compliance controls. The CFPB specifically mentions several aspects of a strong ECOA compliance program, including a current policy statement, robust and up-to-date ECOA training programs, ongoing compliance monitoring, review of loan policies and marketing, loan data analysis, and management oversight.¹

When implementing CFPB and other regulatory change in similar consumer lending environments, lenders often struggle with meeting the evidentiary requirements of regulators. Incorporating the ability to conclusively show that a control was run and to document the outcomes should be integral parts of the process subject to regulatory scrutiny. Making this data accessible at an account level and available to systematic reporting further enhances its usefulness to address future regulatory inquiries.

**Develop pricing and profitability capabilities**

Launching nonreserve products will likely challenge many indirect lenders’ pricing capabilities, since they could be forced to adapt to new pricing drivers and structures. Similarly, lenders who maintain a reserve-based product structure may benefit from improving their pricing competencies as they face a changing, more complex, competitive environment.

Interest in advanced pricing management tools among indirect lenders also may gain momentum as new products stress existing pricing methodologies. Pricing for a new nonreserve product may require lenders to consider average amounts financed and average dealer reserve spreads to create fees comparable to a reserve-based product. Additionally, lenders should consider factoring competing flat-fee pricing structures, risk premiums, and costs of funds as pricing inputs. Finally, lenders may need to consider end-customer demand to set rates.

Depending on how a lender elects to handle chargebacks in a nonreserve program, it also may need to calculate and manage a “no-chargeback” pricing structure. This is similar to the manner in which some lenders currently split dealer reserve payments to offer a no-chargeback dealer reserve plan and could potentially require additional data inputs to analyze payoff, repossession, and charge-off patterns.

Finally, lenders will likely need to develop tools and processes to monitor pricing strategy execution to assess the extent to which the revenue projected during the pricing analysis is realized. This analysis serves as a critical point of feedback to refine pricing algorithms and processes.

Translating the strategic direction, regardless of approach, into effective, compliant operational execution will likely distinguish the lenders that can thrive in the post-CFPB auto lending environment by continuing to add dealer and customer value while profitably growing their portfolio.

**Next steps**

As lenders seek to determine their strategic direction, it is apparent that the CFPB’s announcement has raised questions that need answers. As of September 2013, the CFPB has provided little elaboration on the guidance contained in its initial five-page bulletin and has not provided details of the methodology leading to its findings. While the industry formulates its response and awaits additional insight, lenders can consider several steps to create a foundation for their eventual strategic initiatives:

**Strengthen fundamental controls**

Regardless of the CFPB’s eventual guidance, its focus on effective, documented, and demonstrable ECOA controls is clear. Lenders should take this time to reassess their current controls in light of the CFPB’s guidance and should leverage lessons learned by other lending sectors from implementing CFPB guidelines.

¹ Source: Consumer Finance Protection Bureau, Bulletin 2013-02, March 21, 2013
Revisit service delivery metrics and performance
Taking a hard look at core service delivery performance in the originations process could pay dividends as the competitive landscape evolves in response to the CFPB’s initiative. Regardless of the strategic path a lender chooses, being perceived as “easy to do business with” and responsive to dealers’ needs could offer a marketplace advantage. By making a dedicated effort to analyze service delivery metrics, reporting and recent performance and goals, a lender’s operational staff could maintain the appropriate focus and provide an opportunity to address latent problems before the competitive pressure increases.

Plan a nonreserve “what-if” scenario
Formulating a high-level plan for a nonreserve product, even for those who favor enhancing their reserved-based program, may provide a hedge against the CFPB’s direction.

For lenders planning to enhance their reserve-based products, this type of planning exercise should force a candid discussion of the people, processes, technology, and data required to support a nonreserve product. It should focus on providing an actionable starting point in the event that it becomes required to implement nonreserve products.

For lenders planning on converting to nonreserve products, this plan should be the foundation of their larger strategic and operational effort to launch the new program.

Despite the regulatory uncertainty, auto lending is likely to remain an attractive and exciting segment of the financial services market amid growing auto sales and good access to funding. Experience in other consumer lending sectors shows that market leaders anticipate and aggressively implement change rather than becoming mired in a cycle of regulatory reactions that divert focus away from serving their customers and capitalizing on market opportunities.