

Paving the Way to Profitability

How Auto Lenders Can Avoid the Mortgage Crisis Pitfalls

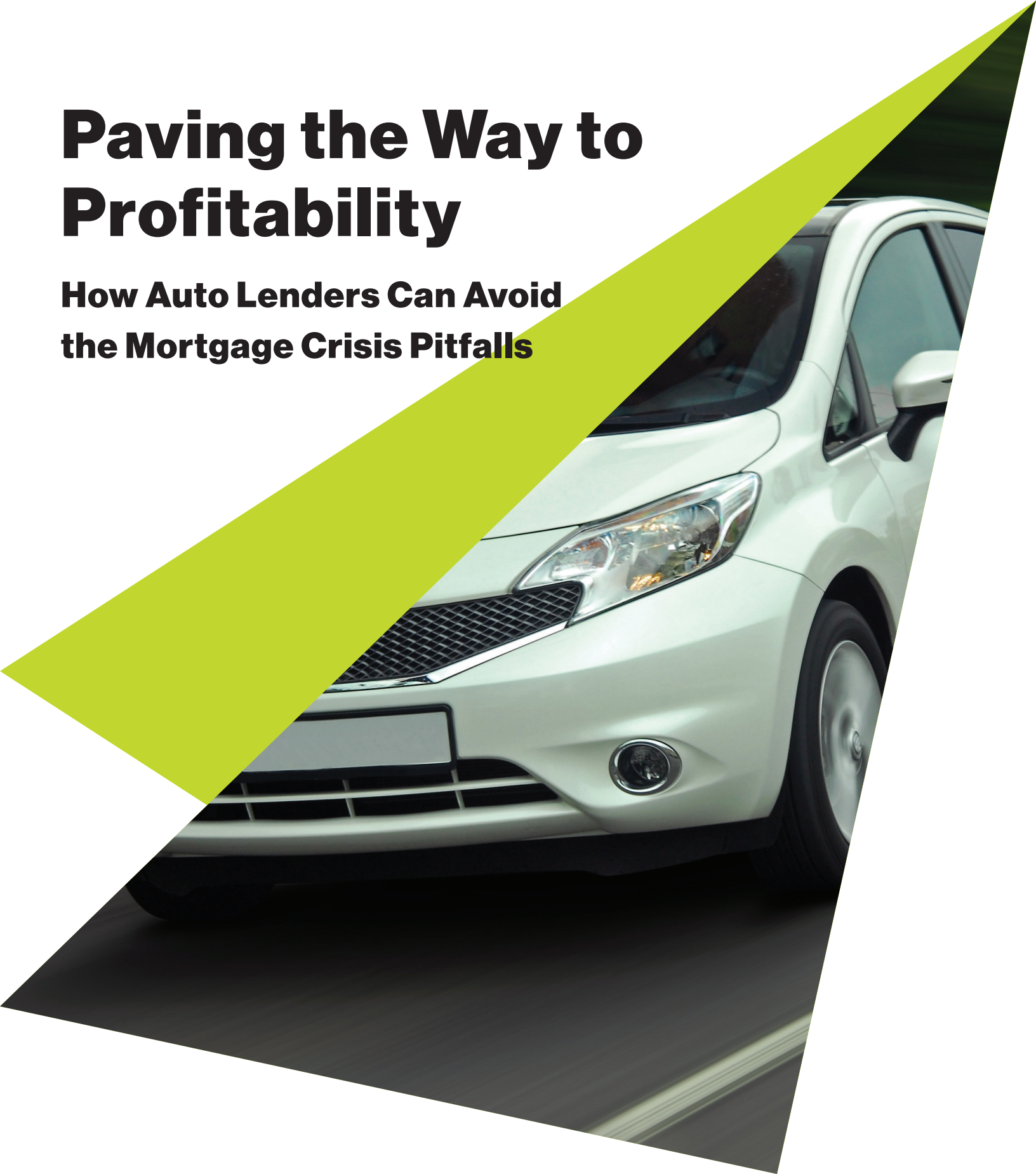


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Paving the Way to Profitability

How Auto Lenders Can Avoid the Mortgage Crisis Pitfalls

Introduction

As auto loan originations near historic highs, lenders are concerned that a significant economic slowdown may result in a spike in loan defaults. There are lessons learned from the mortgage crisis that auto lenders can implement now to help manage regulatory and operational risks while maintaining profitability during a correction.

Auto lending has accelerated during the economic recovery. Auto loan originations reached an all-time high of \$584 billion in 2018, and the total auto loan debt outstanding among U.S. consumers is more than \$1.27 trillion, or about 9% of all household debt¹.

Recent reports suggest that the quality of auto loans may be deteriorating, raising concern that lenders may be vulnerable to higher losses.

The New York Fed Consumer Credit Panel confirms delinquency is creeping higher stating that the percentage of borrowers who were behind three months or more on their auto loans rose to 2.4% in the fourth quarter of 2018, the highest level since 2012.²

More than 7 million Americans had auto loans that were 90 or more days delinquent at the end of 2018, which is up by more than a million from the previous high at the end of 2010.³

As loan delinquencies rise, additional regulatory scrutiny is sure to follow.

To maintain profitability, auto lenders should consider the lessons from the mortgage industry, including tightening risk and operational frameworks and streamlining operations to prepare for the increase in default volume.

1. Haughwout et al., "Just Released: Auto Loans in High Gear," Liberty Street Economics, February 12, 2019, <https://libertystreeteconomics.newyorkfed.org/2019/02/just-released-auto-loans-in-high-gear.html>.

2. Andrew Haughwout et al., "Just Released: Auto Loans in High Gear," Liberty Street Economics.

3. <https://libertystreeteconomics.newyorkfed.org/2019/02/just-released-auto-loans-in-high-gear.html>.

Current Auto Concerns Mirror Those of Mortgage Crisis

There were essentially three leading indicators that preceded the mortgage crisis: major expansion in the availability of credit (including sub-prime); legacy processes, technology and controls; and limited risk and compliance governance.

Eventually, an expanded mortgage lending credit box led to the realization that many loans were impaired, with little probability of repayment. Subsequently, servicing operations and third parties were ill-prepared for the default volume, which resulted in customer-facing issues quickly multiplying. The result was sweeping regulation, the advent of the Consumer Finance Protection Bureau (CFPB), and many consent orders requiring significant changes to operational risk and control frameworks.

All of this came at a tremendous cost — direct fines, sharp increases in back-office costs, and the lost time and opportunity cost of resources shifted away from growth and expansion into compliance work.

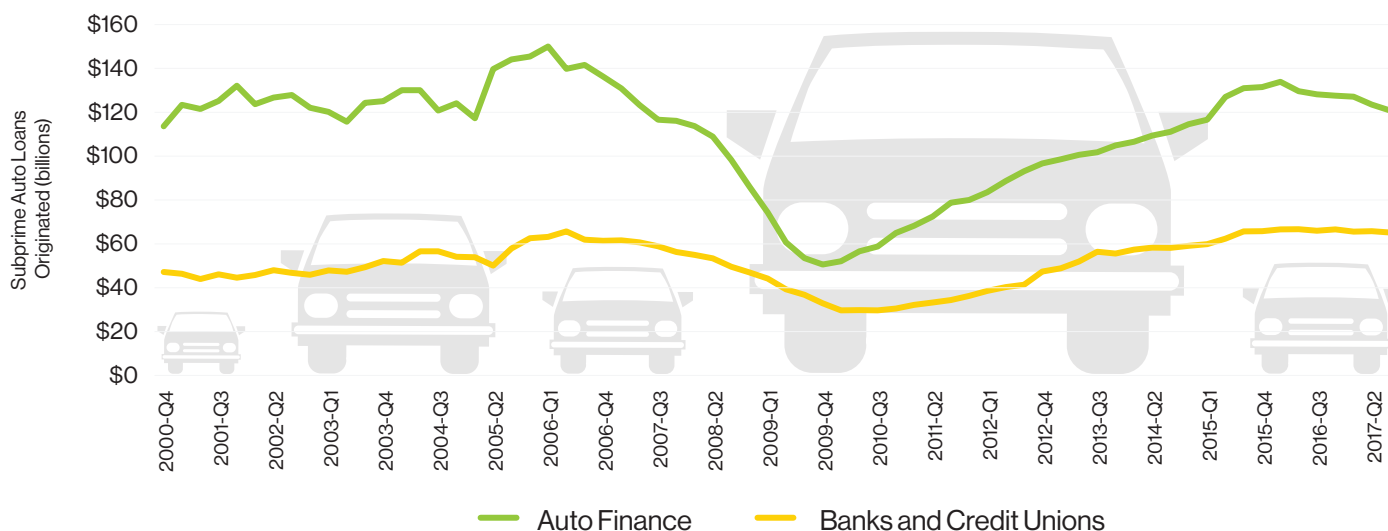
Although current auto lending trends are arguably less severe than the mortgage issues of the past, auto lenders face similar issues in their portfolios, servicing operations, and compliance.

Driving Parallels Between Auto and Mortgage Lenders

1. Changes to Credit Availability

- Loan-to-value ratios have steadily risen due to an increase in negative equity and ancillary products as a percentage of vehicle value. Average loan-to-value ratio of securitized auto loans was 110 percent on subprime loans in 2017; it was 96 percent for prime loans⁴.
- Loan term has crept to its highest historical average at 68 months and the percentage of six-year or longer loans rose from 26 percent in 2009 to 42 percent by 2017. Mortgage lenders prior to the crisis had also expanded term beyond 30 years and even interest only.⁵
- The credit box was expanded to produce more near prime and subprime business as a percentage of loan portfolios. While many auto lenders have begun pulling back from lower credit scores over the past few years, expanded front- and back-end advance products and; many of the sub-prime and near prime loans still on the books are driving higher servicing exposure and operations costs.

Auto Loan Originations to Borrowers with Low Credit Scores by Lender Type



4. Kenneth P. Brevoort, et al., Consumer Financial Protection Bureau, Quarterly Consumer Trends: Growth in Longer-Term Auto Loans, November 2017.

5. Melinda Zabritski, State of the Automotive Finance Market, Experian, Q3 2018.

6. New York Fed Consumer Credit Panel and Equifax, Auto Loan Originations by Lender Type and Credit Score.

2. Legacy Technology, Processes and Controls

For mortgage lenders, after the “credit box” issue was addressed, much of their attention turned to the back office, where disconnected or broken processes came under the regulatory and enforcement microscope. Particularly, issues directly impacting the borrower, including foreclosure, military protections, bankruptcy, credit reporting and a dependence on third parties became the focus of regulatory scrutiny.

Auto lenders could be looking into the same mirror, as regulators are increasingly investigating processes that directly impact the consumer such as payment processing, auto repossession, ancillary product cancellation practices, lender liability in offering GAP and claims processing, military protections, bankruptcy processing, credit reporting and disputes.

3. Insufficient Risk and Compliance Governance

At the outset of the mortgage crisis there were few robust enterprise risk management frameworks in place. Governance was often viewed as limited to the board, outside the audit function, and was composed of limited or nonexistent detective controls.

In the wake of the mortgage crisis, many auto lenders have followed through with more controls and quality assurance practices. The key question is whether those safeguards cover the more recent regulations and guidance at both the federal and state levels and include oversight of key third parties.

An Auto Lending Call to Action

To stay competitive, auto lenders should focus on shoring up the back-office to prevent the potential negative outcomes of the mortgage crisis — specifically assessing:



Back-Office Operations

“Assess and address,” because regulators are actively engaged. Regulatory scrutiny is currently paid to auto-specific issues like: wrongful repossession, ancillary products, GAP insurance, insurance loss, credit reporting, and the Servicemembers Civil Relief Act (SCRA).

Federal guidance and ever-increasing state-specific requirements around these practices, coupled with increasing frequency in examinations, means institutions should fully assess their processes and controls.

In recent supervisory letters, the CFPB has focused on repossession where customer, payments were not applied correctly or in a timely manner (Q1 2017 CFPB Supervisory Highlights). In the Q1 2019 highlights, mishandling the cancellation of ancillary products by failing to cancel or misapplying the proceeds came into focus.

Credit reporting accuracy and proper dispute handling still commands regulatory scrutiny. The focus now is not only on whether Fair Credit Reporting Act errors have been addressed, but whether a lender has an ongoing monitoring program to prevent reoccurrence. Auto lenders should quickly assess these processes, install best practices, controls and reporting in their operations.



Policy and Procedures

Ensure policies and procedures (P&P) are updated for all requirements, and that system and operational flows are mapped to those requirements. For instance, now might be the right time to install or enhance a robust change control process that pulls in current but ever-changing state requirements. Make sure P&P are in alignment with what your operational team is executing against on the floor, and that detective controls reveal that adherence.



Compliance Management Systems

As lenders seek efficiencies in operations, an opportunity exists to automate the compliance management function or outsource transactional testing, enabling the deployment of resources against higher value activities (collections, customer service, thereby positioning lenders for a prospective economic downturn.

A proactive compliance management system should elevate key risk indicators for action, include all high-risk processes, and have timely reporting and actionable testing results as components of effective diagnostics. Regulators expect to see compliance in culture, in practice, and in measurable outcomes.



Risk Models

As lenders continue to refine the optimal mix in credit acquisition, underwriting and collection models must be reevaluated and, when changes are made, validation is required to determine if those models are predictive. Increasingly, lenders are leveraging alternative data in their models to better predict performance. The importance of risk model validation is critical given potential exposure to consumer distress.



Third-Party Oversight

One of the most significant issues in the mortgage crisis was insufficient oversight of third-party servicers and vendors such as attorneys, debt collection companies, debt buyers and suppliers, and business process outsourcing in general. The financial services industry seems to have largely learned those lessons, but risks remain. These include a lack of transactional testing of third and fourth parties, and a limited governance process required to maintain service level and master servicing agreements. Lenders are increasingly looking to automated tools and tracking mechanisms to manage these risks and exit non-compliant operators.

Even when a full third-party oversight program is in place, ever-changing requirements and operational change means lenders must be diligent, stay current, install controls and test areas that specifically carry the risk of borrower harm.

As lenders grapple with rising defaults and delinquencies and prepare for an economic downturn, there is time to steer clear of known pitfalls. By applying lessons learned from the mortgage crisis — including stronger underwriting, advanced technology, and prudent risk and compliance management strategies — auto lenders can minimize distress exposure.



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Learn more about what has auto finance lenders stuck in park by viewing our interactive infographic: <https://www.Guidehouse.com/insights/financial-services/2019/auto-lenders-infographic>.



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