



Indirect automotive finance

Current regulatory outlook
and potential risks

Over the past several years, indirect automotive lending has experienced growth due to such factors as a low interest rate environment, lowered credit requirements, historically high pre-owned vehicle values, and an increasing number of financing options (e.g., extended terms, no/low down payments, sub-prime offerings). With increasing automotive sales and leasing volumes, the automotive finance industry has come under increased scrutiny from the Consumer Financial Protection Bureau (CFPB), which recently took several enforcement actions in response to what it considers unfair and potentially discriminatory pricing of automobile loans and leases. Given this heightened oversight, financial institutions (or “institutions”), including both traditional and non-traditional auto lenders, may be wise to prepare to demonstrate their compliance with consumer protection-related laws, rules, regulations, and compliance management expectations (collectively, “regulatory requirements”).

Shifting auto finance landscape

Auto loans are currently the third largest household debt in the US, behind only mortgages and student loans. Automotive loan volumes grew 21 straight quarters since Q1 2011.¹ Consumers held about \$1.005 trillion in outstanding auto loans in the first quarter of 2016, whereas total debt was \$.905 and \$.813 trillion in Q1 2015 and 2014, respectively.² The auto leasing market is also experiencing tremendous growth as more than a quarter of new cars are now acquired through leases. The recent growth in automotive leasing volume could have

a deflationary effect on pre-owned values due to increasing numbers of leased vehicle returns, with impacts to the automotive finance industry that remain to be seen. Other trends impacting the growth of the auto lending markets include:

- Loose underwriting standards, extended loan terms, higher delinquencies and loss rates, high loan-to-values (LTVs), and record low rejection rates (3.3 percent Q2 2015).²
- Record high average loan terms during Q1 2016 where new and used auto loan maturities averaged 68 and 66 months, respectively.⁴
- A rise in new vehicle average loan amount for Q1 2016 rose to \$30,032 from \$28,711 a year earlier, alongside an average monthly payment for new vehicles, which increased to \$503 from \$488 a year earlier.⁵
- Maturities greater than six years for nearly 30 percent of new auto loans, although historically this has been rare. In Q1 2016, leases surpassed 30 percent of all newly financed automobiles.⁶
- Growth of balances of loans and leases averaging approximately 11 percent year over year from Q2 2014 through Q4 2015. However, 60-90 day delinquencies have outpaced loan growth, hitting a delinquency rate of 21 percent, 15.5 percent, and 24 percent, respectively, for Q2, Q3, and Q4.

Loan and lease balances and delinquencies: Increases and decreases in total balance (\$)

Quarters	Auto lender type	Loan growth %	30-59 DPD	60-89 DPD
1Q'16 vs. 1Q'15	Banks	7.86%	-	-
	Captive auto	6.09%	-	-
	Credit union	15.81%	-	-
	Finance company	18.88%	-	-
	Total YoY growth	11.04%	-	-
4Q'15 vs. 4Q'14	Banks	7.67%	7.80%	20.08%
	Captive auto	6.09%	8.14%	21.26%
	Credit union	15.87%	12.97%	16.43%
	Finance company	22.96%	20.13%	31.80%
	Total YoY growth	11.51%	12.71%	24.87%
3Q'15 vs. 3Q'14	Banks	8.17%	9.53%	15.63%
	Captive auto	5.68%	9.61%	23.57%
	Credit union	16.42%	12.48%	10.02%
	Finance company	20.15%	6.91%	13.76%
	Total YoY growth	11.26%	8.92%	15.50%
2Q'15 vs. 2Q'14	Banks	8.03%	12.38%	19.51%
	Captive auto	4.04%	8.20%	20.78%
	Credit union	17.19%	15.46%	18.24%
	Finance company	20.47%	18.68%	22.86%
	Total YoY growth	10.94%	13.75%	21.08%

DPD = Days past due

Source: State of the Automotive Finance Market Q1 2016, Experian Information Solutions, Inc., June 1, 2016.

¹ Quarterly Report on Household Debt and Credit, Federal Reserve Bank of New York, February 2016 [https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2015Q4.pdf]

² State of the Automotive Finance Market Q1 2016, Experian Information Solutions, Inc., June 1, 2016. [http://www.experian.com/automotive/automotive-credit-webinar.html]

³ SCE Credit Access Survey of Consumer Expectations, New York Fed Microeconomic Data, June 2015.

⁴ State of the Automotive Finance Market Q1 2016.

⁵ Ibid.

⁶ State of the Automotive Finance Market Q1 2015, Experian Information Solutions, Inc., June 1, 2015.

CFPB supervision overview

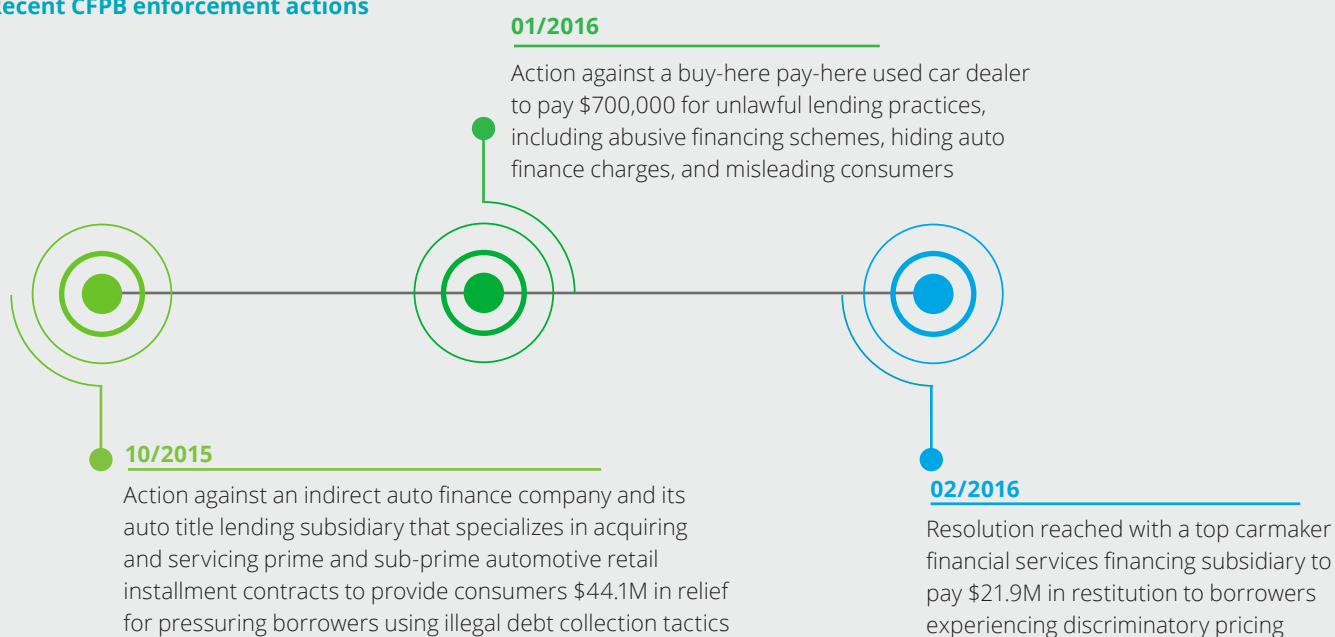
In 2015, the CFPB expanded its focus from mortgage and credit card lenders to the auto lending segment. As previously demonstrated in the mortgage industry, the CFPB is putting the consumer first and setting new standards and requirements to increase consumers' awareness and knowledge of financing agreements. In June 2015, the CFPB finalized a rule that exercised the authority given to the agency by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to supervise "larger participants" of certain markets for consumer financial product or services, as the CFPB defines by rule.⁷ The rule governs larger participants in the market of automobile financing. It also introduced the "Automobile Finance Examination Procedures" that CFPB examiners use to assess potential risks to consumers and

determine whether the institutions subject to CFPB supervision are complying with applicable regulatory requirements. These regulatory requirements include but are not limited to the Equal Credit Opportunity Act (ECOA), Truth in Lending Act, Consumer Leasing Act, and the Dodd-Frank Act, which includes prohibitions of unfair, deceptive, or abusive acts or practices (UDAAP). It is also worth noting that other regulators, such as the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), have responsibility for enforcing regulatory requirements like the Servicemembers Civil Relief Act (SCRA), with which participants in the automobile financing market must comply.

The CFPB's definition of "larger participants" refers to non-bank institutions that provide, acquire, or refinance 10,000 or more loans or leases per year. In recent years,

the burden of responsibility has shifted. Institutions are no longer responsible only for the financing actions in-house. They are also held accountable for what dealers and other vendors do on their behalf. As a practical example, the CFPB has held financial institutions responsible for ECOA non-compliance even as a result of dealership practices—particularly when involving dealer markup of institution buy rates to earn a finance reserve. The CFPB's position is that the manner in which rate markups are applied creates discretion and significant risk that the extension of credit may not comply with the ECOA or it may potentially represent a UDAAP.⁸ 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 consumer.

Recent CFPB enforcement actions



⁷ Defining Larger Participants of the Automobile Financing Market and Defining Certain Automobile Leasing Activity as a Financial Product or Service, Consumer Financial Protection Bureau, June 5, 2015. [http://files.consumerfinance.gov/f/201506_cfpb_defining-larger-participants-of-the-automobile-financing-market-and-defining-certain-automobile-leasing-activity-as-a-financial-product-or-service.pdf]

⁸ CFPB Bulletin 2013-02, March 21, 2013. [http://files.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf]

Potential areas of CFPB examination focus

CFPB examinations can vary between being fairly broad or narrowly focused in the sense that financial institutions are evaluated against overall compliance management standards as well as specific consumer protection regulatory requirements.

With regard to auto lending in particular, financial institutions should be prepared to demonstrate both a working compliance management system (CMS)⁸ and individual regulatory requirement compliance. Therefore, institutions should consider both their compliance and legal responsibilities with respect to all phases of the credit or lease transaction—from origination to servicing to collection activities—to cover the end-to-end lifecycle of the products and services they offer to consumers. Some examples regarding where institutions should consider focusing their time and efforts in advance of a formal examination by the CFPB are provided below.



Rate practices

Communication of rate markup policies to dealerships. Financial institutions should clearly outline rate practices and policies and convey these requirements in a clear and concise manner to their dealer base. This should include guidelines for the dealer to follow regarding markup (reserves) of rates. While limiting markup may reduce the potential for CFPB enforcement actions, this practice still leaves room for potential

discriminatory pricing allegations. A way to limit this exposure: disallow rate markup at the dealership level and pay dealers a flat fee based on the amount financed on the contract, rather than leaving the rate determination (and negotiation) to the dealership representatives.

Financing and markup (reserves) of “add-on” products (extended warranties, insurance, etc.). The dealership finance and insurance (F&I) office typically will offer an array of warranty and insurance products for the consumer to consider. The lender often does not have control over these items. But they still are subject to regulatory risk because these items are being financed as part of the automobile loan. In addition, with the increase in popularity of wheel and tire warranty programs, many captive lenders offer these products branded under the manufacturer name and allow the dealership to mark up the price of these contracts, leaving themselves open to potential UDAAP exposure.



Credit underwriting

Requirements and consistency of decisioning. Lenders should have credit underwriting policies in place that clearly outline the criteria for decisioning applications on a non-discriminatory and consistent basis. Credit decisions should be made using only verifiable information provided on the credit application. Prohibited outside factors, including but

not limited to race, sex, religion, national origin, and marital status, should not be considered (i.e., requirements within ECOA). Lenders should also consider decisioning factors, such as imposing different terms or conditions required for loan approval. For example, automatic withdrawal of monthly payments or a required larger down payment could potentially be considered a discriminatory practice if standards are not applied on a consistent basis. In addition to Fair Lending considerations, the Electronic Fund Transfer Act (EFTA) prohibits lenders from requiring, as a condition of loan approval, a consumer’s authorization for loan repayment through a recurring electronic fund transfer except in limited circumstances.

Documentation/information requirements.

Lenders should establish a consistent list of documents required for credit review and consideration. This includes requesting similar financial documentation from consumers whether they are applying for a loan or lease. Institutions that fail to require the same documentation from all borrowers could potentially face allegations of discriminatory credit decisioning practices.



Lease-end practices and policies

Lease-end inspection process and related charges. While not an immediate concern, lease-end practices is an area

⁸ A Compliance Management System (CMS) is how a supervised entity establishes compliance responsibilities; communicates those responsibilities; ensures that responsibilities for meeting legal requirements and internal policies are incorporated into business processes; reviews operations to ensure responsibilities are carried out and legal requirements are met; and takes corrective action and updates tools, systems, and materials as necessary. [<http://consumerfinance.gov/guidance/supervision/manual/>]

that has potential for CFPB scrutiny in the near future. Many leasing companies use third-party inspection companies to perform lease-end inspections. While this process is common in most leasing contracts, consumers are often confused by the charges they incur on these lease-end inspections because the related disclosures are often buried in the initial leasing contract. While these charges are often negotiable and some companies offer to waive charges if the consumer finances or leases another vehicle with the company, consumer confusion about this practice could potentially lead to claims of unfair or deceptive practices resulting in UDAAP risk.

Residual negotiations for consumers purchasing their vehicle at lease end.

Consumers leasing their vehicles have the opportunity to purchase the vehicle at the end of a lease for a price known as the “residual value,” which was agreed upon at contract signing. While this practice in and of itself does not pose many threats of discriminatory nature, some lenders prefer to negotiate the final price of the vehicle with

the consumer rather than take the financial risks associated with sending these off-lease vehicles to auction. This practice could result in Fair Lending risk if consumers with the same vehicle and same residual value on a contract end up paying very different prices for the same car. One potential approach to mitigating this risk is to not negotiate residual values on vehicles.



Collection practices
Compliance with the Fair Debt Collection Practices Act (FDCPA). Collections is a major focus for the CFPB and institutions should understand consumers’ rights and their own responsibilities when attempting to collect specific debts. Generally speaking, lenders are prohibited from harassing consumers, including excessive telephone calls, abusive language, and making certain threats. Institutions should also be cautious not to disclose certain consumer debts to unauthorized parties and to provide

consumers with proof, as requested, that they actually owe the debt. Although an institution that collects its own debts under its own name is not covered under the FDCPA, as a general rule most institutions will follow the provisions and embrace the spirit of the rule.



Consumer complaints handling

Response time. Companies must provide an initial response within 15 days after receiving a consumer complaint via the CFPB. An initial response may indicate “in progress” but an additional and final response must be provided within 60 days of receipt of the complaint. Final responses must include steps a company has taken to respond to the complaint, including describing and attaching evidence of communications to and from the consumer and any planned follow-up actions.



⁹ Ibid.

Meeting CFPB expectations

Given the CFPB's current position, as well as recent actions indicated above, it is clear that there will be heightened scrutiny and expectations of the auto finance industry, including a more robust examination and enforcement agenda. Regulators want to see that organizations have proper governance and oversight in place and that policies are being followed. In addition, regulators want to know if organizations understand inherent risks/gaps present in their compliance management programs and if they have a defined plan and timeline to remediate these identified risks. One way this can be achieved is through a broad framework that can drive consistency, transparency, and accountability. Organizations should demonstrate that their framework is functioning properly through quality assurance reviews, compliance testing activities, reporting, and remediation.

Whether the organization is building upon a mature consumer compliance program or establishing a new program, it may be time to ask: Are we prepared?



Compliance program framework

Baseline expectations. A baseline expectation of the CFPB is for institutions under its supervision to develop and maintain a CMS that is integrated into the

product and service lifecycle, including design, delivery, and administration. Each element of the CMS, when properly constructed, facilitates and reinforces the others and will help institutions manage compliance risks. The following risk management framework components illustrate CFPB expectations for what comprises an adequate CMS.⁹

Board of directors and management oversight. The board of directors is ultimately responsible for developing and administering a CMS that seeks to achieve compliance with federal consumer financial regulatory requirements and addresses and prevents associated risks of harm to consumers. In a non-depository consumer financial services company, that ultimate responsibility may rest with a board of directors in the case of a corporation or with a controlling person or some other arrangement.

Compliance program. An institution supervised by the CFPB should establish a formal, written compliance program consisting of the following components: governance, policies, and procedures; risk assessment; monitoring; training; and corrective action. The program generally should be administered by a chief compliance officer. In addition to being a planned and organized effort to guide the entity's compliance activities, a written program represents an essential source document that may serve as a training and reference tool for employees. A well-

planned, implemented, and maintained compliance program will prevent or reduce regulatory violations resulting from non-compliance, protect consumers from associated harms, and help align business strategies with outcomes.

Consumer complaint response. An effective CMS should demonstrate that a supervised entity is responsive in handling consumer complaints and inquiries. Intelligence gathered from consumer contacts should be organized, retained, and used as part of an institution's CMS.

Compliance audit. Audit coverage of compliance matters is the fourth component of an effective CMS. The audit function should review an institution's compliance with federal consumer financial regulatory requirements, check for adherence to internal policies and procedures, and be independent of both the compliance program and business functions that include consumer sales or service. A compliance audit program provides a board of directors or its designated committees with a determination of whether policies and standards adopted by the board to guide risk management are being implemented to provide for the level of compliance and consumer protection established by the board. The audit should also identify significant gaps in board policies or standards.



Specific actions to consider in the near term

Establish and assess. Financial institutions should establish a CMS rooted in the CFPB's expectations and consider assessing the compliance organization's CFPB examination readiness. Some strategic questions to ask during the assessment phase include:

- What is the size and composition of the compliance infrastructure (e.g., people, process, and technology) needed to

remain compliant—and avoid the major fines and reputational risks that come with enforcement?

- Is the entire organization on solid ground when it comes to compliance?
- How will compliance support core business goals while maintaining oversight, acceptable risk management, and third-party supervision?

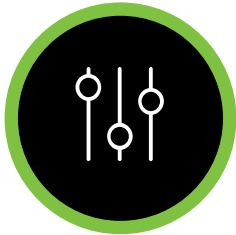
Answers to these questions can help an organization understand the current state of the key components for a compliance framework.

A call to action on CMS

The CFPB has left little doubt that the automotive finance industry will be a priority moving forward. CFPB supervision works to ensure that banks and non-banks play by the same rules, which in theory provides consumers with the benefits of federal consumer financial protection regulatory requirements on a consistent basis. To meet the CFPB's expectation, financial institutions must work diligently to establish or enhance their organizations' CMS, including monitoring the actions of their dealer networks.



How Deloitte Advisory can help



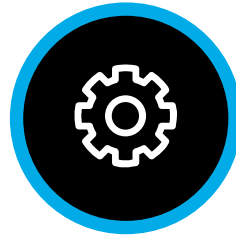
Assess

Understanding and assessing the compliance organization for CFPB readiness

Deloitte Advisory has an established methodology for identifying the critical components of a compliance program/CMS, as well as a risk and compliance organization assessment that leverages a quantitative and qualitative approach. As a result of these efforts, Deloitte Advisory can help define and categorize the organizational compliance risks and transparency of the compliance organization.

People

Deloitte Advisory has deep compliance capabilities with access to hundreds of professionals specializing in risk and compliance solutions, including former regulators, chief compliance and risk officers, and those with C-suite and boardroom backgrounds.



Remediate

Remediate gaps of the compliance program framework/CMS

Many organizations routinely, through internal or third-party assessments, identify gaps within the compliance program/CMS. Deloitte Advisory can work with you to help identify practical, actionable, and implementable enhancements to the compliance program framework and put those recommendations into action.

Experience

We have significant practical experience assisting consumer lending institutions with the assessment of their compliance programs/CMS, offering meaningful and automotive industry-specific insight into the enhancements to their programs and providing remediation services to put recommendations into action. Furthermore, we understand the relationship between the auto dealer and the auto manufacturer and the strategies for managing the compliance challenges that exist through that affiliation.



Prepare

Perform readiness assessment of CFPB compliance

CFPB readiness assessment includes:

- Governance assessment to understand the board and management oversight
- Compliance program components
- Consumer complaints system
- Compliance audit function
- Compliance risk management review for in-scope regulations
- Compliance risk management review for in-scope, product-based procedures

Value

Our demonstrated approach is designed to assess and help organizations build a compliance program/CMS that will address and enhance the management of compliance risks. Our advanced toolset and enablers allow the Deloitte Advisory team to effectively execute, and to provide stakeholders with actionable recommendations.

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