Indirect Lending / Leasing Risks

Bryan W. Mogensen, CPA, Partner

CliftonLarsonAllen

cliftonlarsonallen.com

Presenter - Bryan W. Mogensen, CPA

- Partner with CliftonLarsonAllen LLP Credit Union Group in Phoenix, AZ
- Over 20 years of experience working primarily with credit unions
- Speaker/Presenter at:
  - AICPA National CU Conference
  - ACUIA National Conference
  - Various State League and Chapter Meetings
  - CUES
- Graduate of University of Wisconsin – Milwaukee, WI
- Member of:
  - AICPA
  - Arizona Society of CPAs
- On the AICPA National Credit Union Planning Committee

About CliftonLarsonAllen

- Founded in 1953
- Top 10 CPA firm with more than
  - 3,600 professionals
  - Serving clients from 90 offices across the country
  - 18 dedicated credit union partners nationwide
- **# 1** Provider of audit services to credit unions over $40M in assets in 2012 (Callahan & Associates)

Session Overview

Session Overview

With all that has happened with the national and local economies over the past several years, the extension of credit has had to adapt to the changing conditions brought on by the "great recession"

This has affected *all forms of lending* including and perhaps most notably indirect lending

Session Overview

As a result of the recession and in the lending world of today, credit unions have had to identify:

- Who are your potential borrowers?
- How has their capacity to afford a loan been affected?
- How has the indirect lending process had to adapt?

Session Overview

Today, all forms of lending, including indirect lending have to be re-examined

- Go back to the basic concepts of lending
- Better quality underwriting so as not to over-extend borrower
- Re-examine underwriting standards

Session Overview

Common areas that have been re-examined:

- Elimination of long term loans secured by questionable collateral
  - i.e. 84 month loan on a 2010 KIA Rio
- Proof of employment
- Required proof of income on more borrowers
  - Credit scores under 700 or 680
- Re-establishment of acceptable debt ratios
- Reduction of acceptable LTV limitations
  - How high will you now go – 125%, 110%, 100%?

Session Overview

How can a Credit Union accomplish all of that?

- Re-examine indirect loan policy/procedures language
- Re-training of indirect loan personnel to new standards

Above all: **OVERSIGHT**

In this session we will:

- Discuss how indirect lending differs from other forms of lending
- Overview indirect lending issues and concerns
- Identify risks in indirect lending and determine necessary controls
- How credit unions can more effectively monitor their indirect lending program
- Discuss the risks and pitfalls in leasing

Indirect Lending Today and Differentiators

CliftonLarsonAllen

cliftonlarsonallen.com

Indirect Lending Today

- According to industry sources, over 75% of financed car loans are processed through a form of indirect lending
- This is the result of the convenience of purchasing a vehicle and obtaining financing at the same time

“one stop shopping”

The Definition of Indirect Lending

Definition of indirect lending may best be summarized as:

"A form of lending where the loan application is originated by a third-party (generally a car dealer or other form of collateral dealer) where the financial institution does not directly converse or speak to the loan applicant"

- Because the financial institution does not actually speak to the loan applicant, the financial institution <u>*must place trust in information provided by third-party*</u>
  - This is primary source of risk associated with indirect lending programs and reason that strong controls are needed to adequately protect the Credit Union

Indirect Loans versus Direct Loans: *Key Differences*

- Indirect loan applications and documentation are generally created and submitted by dealer
  - Including how non-member applicant qualifies for membership
- For indirect loans, dealer documents, including loan application, may differ significantly in requested information obtained compared to information obtained in a direct member loan application interview

Indirect Loans versus Direct Loans: *Key Differences*

- Indirect loan officer does not generally interview loan applicant and has no direct way of knowing if any follow-up questions are actually answered by the applicant or not
- Because of number of financial institutions competing for each loan, there is significant time-pressure to reach a loan decision
- For indirect loans, there is generally less control over loan amount and loan-to-value ratio because of subsequent indirect dealer "add-ons"

Indirect Loans versus Direct Loans: *Key Differences*

- Distinct difference between flow of communications between credit union indirect loan officers and retail dealerships compared to the flow of communications between credit union loan officers and members applying directly for a loan
  - In addition, the *psychology of communication* for both is vastly different
- For indirect loans, there is a general reliance on indirect dealers to perform many of required loan tasks including: recording of collateral liens and providing acceptable copies of stipulated documentation

Indirect Lending Issues and Concerns

CliftonLarsonAllen

cliftonlarsonallen.com

Indirect Lending Concerns

- Growth
  - Retaining or increasing market share
- Interest rates
  - Overcoming manufacturer offers/incentives
- Fees and affect on yields
  - How much should we pay the dealers
  - How does that affect our yields
- Member interest
  - Why borrowers do not finance at credit union
- Disastrous indirect programs

Red Flags

- High concentration of indirect loans to total loans or net worth without adequate controls
- Incentive programs tying loan officer bonuses to indirect loan volume
  - Without consideration for loan delinquencies or losses
- Inadequate analysis of overall indirect loan portfolio performance
  - What is true yield after dealer fees, loan losses and indirect costs are applied?

Red Flags

- High instances of 1st payment defaults
- Frequent refinancing of past due interest, repairs or add-on expenses
- Insufficient loan documentation
- Poor oversight over dealer management
- Post mortem analysis of dealer add-ons and member qualifications

Identify Risks in Indirect Lending

Identifying Risks and Effective Monitoring

Most common risks:

- Contract Risk
- Risk of Fraudulent Loans
- Risk of "Power-Booking"
- Risk of the Non-Filing of Liens
- Risk of Employee Misbehavior
- Risk of Violating Fair Lending
- Credit Quality Risks

Identifying Risks and Effective Monitoring

Contract Risk:

- Ensure appropriate clauses that protect Credit Union are contained within contract(s)

Clauses to Consider:

- Dealer fraud language
- “Bail out” language
  - Conditions that permit Credit Union to cancel business relationship with dealer

Identifying Risks and Effective Monitoring

Clauses to Consider:

- Recourse to dealers for fraud or misrepresentation of loan applications or collateral (or both)
- Fee structure (flat fee vs. markup)
- Acquisition of membership eligibility/application package
- Filings of lien documentation

Consult your attorney versed in this for assistance

Identifying Risks and Effective Monitoring

Risk of Fraudulent Loans:

- No mechanism can prevent a dealer from submitting a fraudulent loan application
- Duty of the credit union to detect fraudulent loan applications
- Major method for fraud detection is use of highly trained and “educated” indirect lending personnel

Identifying Risks and Effective Monitoring

Risk of Fraudulent Loans:

- Generally fraudulent loan applications may appear to be "too good to be true"
  - Most likely they are
- Dealers may "tweak" certain aspects of an indirect loan application
  - Income or debts
  - Look for any handwritten changes

Identifying Risks and Effective Monitoring

Risk of Fraudulent Loans – Tools:

- Trained officers understand whether full story of application and prospective deal make sense
- Post disbursal loan quality control review
  - Not as effective
- Post loan disbursal confirmations to borrowers to confirm information about loan including application and collateral information such as the add-ons or accessories the vehicle came with

Identifying Risks and Effective Monitoring

Risk of Fraudulent Loans:

- Can an employee create a fraudulent indirect loan?
- Can an indirect loan officer be influenced by a dealer to grant an indirect loan that does not comply with standard underwriting criteria?
- Favoritism towards a dealer and relaxing of underwriting standards to that dealer
  - Psychology or monetarily driven

Identifying Risks and Effective Monitoring

Risk of Fraudulent Loans:

Detection and monitoring of the behavior of indirect loan officers towards dealers through scrutiny of indirect loan applications and decisioning by dealers is essential

Monitoring not just for funded loans by dealer or by indirect loan officer but also approval/denial ratio of applications by dealer or loan officer

Identifying Risks and Effective Monitoring

Risk of "Power Booking":

- Dealers/sales personnel indicate vehicle purchased has more options/accessories than vehicle actually has
- Not seen by the borrower
  - Only communicated to the financial institution
- Not detected unless vehicle is repossessed and repossession inspection report is compared to list of options/accessories the vehicle had when it was financed
- Confirmation of options with members
  - Marketing opportunity

Identifying Risks and Effective Monitoring

Risk of "Non-Filing" of Liens:

- Generally limited to smaller non-manufacturer dealers ("sand-lots") or limited to dealers with cash-flow problems
- Option for every credit union to periodically (annually) request a copy of the financial statements of every dealer
- Sponsored indirect loan programs (by state credit union leagues or third parties)
  - Typically perform this function but credit union should verify this is performed to assure potential risk is minimized
- Who is monitoring pending titles and how at your credit union?

Identifying Risks and Effective Monitoring

Risk of Employee Misbehavior:

- Dealers aware of psychology of business of indirect lending and often resort to sending compensation to credit union personnel that can be innocent or not
- Some items dealers may send include:
  - Gifts
  - Flowers
  - Cash ("birddog" fees)
  - Tickets to sporting or other events
  - Special promises for special deals on vehicles to be purchased by the employee or family members of the employees
- Make sure your credit union has an employee dishonesty and/or receipt of gifts policy

Identifying Risks and Effective Monitoring

Risk of Violating Fair Lending:

- Those that use risk based/risk pricing form of lending
  - Be careful use of rate-matching, interest rate discounts, or granting flexibility to indirect lending personnel in granting interest rates do not violate fair lending rules
- Written policies need to be specific with respect to how rate matching, rate discounting or exception rates are applied
  - Essential that written policies contain language that states all members are eligible for all such programs

Identifying Risks and Effective Monitoring

Risk of Violating Fair Lending:

- Credit reports can be a risk if written indirect loan policies do not specify which credit report or score model are to be used
  - Use of credit reports must be defined and all borrowers must be treated the same with respect to which credit report is used to determine the interest rate or decision

Identifying Risks and Effective Monitoring

Portfolio Quality Problems:

- Significantly increase loan portfolio in a short period of time
- Positive effects:
  - More loans, more income, more members, more opportunities to increase income through the cross selling of products to new members
- Negative effects include:
  - Fraudulent loans, "power-booked" vehicles, portfolio quality degradation, and greater delinquency, repossession and losses
  - Typical indirect programs have loan losses up to twice that of direct lending

Key is to carefully implement and monitor your indirect loan program

Other Risks

- **Competition: Who Gets the Loan?**

  Auditing rate matching/stretching
- **"The Dealer Factor"**

  Dealers "Figure the Credit Union out"
- **Collateral Quality and Loan-to-Value**

  Auditing stretches on LTV's

Other Risks

- **Credit Quality: What type of borrowers are we getting?**

  "C", "D" and "E" paper grades and also the "true A" paper grade

- **Time Pressure**

  Completeness of loan documentation and the lending decision

- **Repossessions and the "Flooded market"**

  How can auditing assist management with this condition?

Effective and Essential Controls over Indirect Lending

CliftonLarsonAllen

cliftonlarsonallen.com

Necessary Controls

- Comprehensive Written Indirect Loan Policies and Procedures
- Thoroughly trained indirect lending personnel
- Adequate Staffing and Segregation of Duties
- Management Oversight and Audit
- Other Controls

Comprehensive Written Indirect Loan Policies and Procedures

- Foundation for accountability
- Cornerstone for controls
- Must differentiate process of origination, documentation requirements, approval, denial, and documentation of loans submitted from outside sources (dealers)
- Indirect loans often have underwriting standards, interest rates, or terms and criteria that significantly differ from a loan originated directly in-house
  - Clear definition of those different standards, terms, and criteria must be stated to provide necessary guidance for loan origination

Thoroughly trained indirect lending personnel

- Many conditions require use of alternate credit analysis skills, communication skills, and documentation monitoring
- Individuals who are trained to cope with pressures and differences in loan documentation can produce prosperous indirect loan program

Adequate Staffing and <u>Segregation of Duties</u>

- Indirect loan programs result in significant loan growth
  - Can place burden on processing phase for incoming loan documents
- Without adequate staffing to service additional work; opportunities for errors, incomplete documentation, and other risks may occur
- Adequate segregation of duties is essential for indirect lending function to prevent potential for insider fraud
  - Approval
  - Input
  - Monitoring
  - Collection and Charge-off

Management Oversight and Audit

Management must create review process that:

- Incorporates indirect loan reports to adequately monitor positive and negative trends in indirect loan portfolio
- Adequately monitors indirect loan officer performance and production
- Confirmation of indirect loans with members
- Periodic auditing of the indirect loan process

Other Controls: Employee Misbehavior

Considerations for additional review process:

- Auditing employee accounts
- Monitoring underwriters behavior by dealer
- Ethics statements in both HR and Indirect policies, employee signatures on both
- Monitoring the activity of the Business Development Officer (BDO), if applicable

Necessary Detection Tools

- Indirect Lending Reports
- Detail Loan File Review
- Collection Department Input
- Post Charge-off Review of Indirect Loans

Detection Tools

Indirect Loan Reports:

Use of indirect loan reports is an essential control that Management uses to detect anomalies or problem areas indicating weaknesses in an indirect loan program

If adequately implemented and consistently reviewed, indirect loan reports optimize the ability to recognize negative trend conditions in the indirect portfolio allowing sufficient time to react – preventing or minimizing potential negative effects and loss

Detection Tools

Indirect Loan Reports:

- Indirect loans separate computer code to differentiate
- If using credit scoring mechanism, reports include pertinent credit score information to enable analysis of portfolio quality by credit score/grade

Detection Tools

Indirect Loan Reports:

Example reports include, but are not limited to:

- Loan applications received
  - Summary in total and by individual dealer
- Loan applications denied
  - Summary in total and by individual dealer and by indirect loan officer

Detection Tools

Indirect Loan Reports:

- Loan applications processed
  - By dealer and by indirect loan officer
  - If indirect loan officer has undesirable relationship with dealer, indirect loan officer will frequently process unusually high number of indirect applications from that dealer
    - ◊ Especially applications with “marginal/difficult to approve” borrowers

Detection Tools

Indirect Loan Reports:

- Loan applications funded
  - Summary in total and by individual dealer and by indirect loan officer
- Indirect loans denied subsequently overridden to approval
  - Percentage of total overridden loans to total approved
  - Why overrides?

Detection Tools

Indirect Loan Reports by Dealer:

- First payment default
- Loan delinquency
- Repossessions
- Charge-off and loss
- Indirect loans granted in the last 12 months that are delinquent 61 days or more
  - Note: if the resulting number is 8% or more, there is an underwriting problem

Indirect Loan Reports

Indirect Loan Reports By Indirect Loan Officer:

- Summary reports including:
  - Loan officer approval/denial ratio (overall)
  - Loan officer approval/denial ratio (by dealer)
  - Loan officer override approval by total approval
  - Loan officer production, delinquency and loss by dealer

Detection Tools

Detail Loan File Review:

The use of a formal post-disbursal loan quality control review of a sample of indirect loans for compliance with Board approved policies and procedures is essential to tactically monitor:

- Adherence to policies and procedures
- Indirect loan officers
- Assurance for consistent under-writing

Detail Loan File Review

Key provisions in review:

- Compliance with Board approved policies and procedures
- Applications approved that did not fund
  - Why? Call back time?
- How many loan files should be reviewed?
  - By loan officer and experience
  - By dealer
  - Increase if anomalies in report monitored detected
- Who performs this review and how is the review documented?

Detail Loan File Review

Key provisions in review:

- Standard underwriting adherence criteria (rate, term, LTV, etc)
- Funding: the contract, compliance with stipulations, dealer assignment
- Recalculations by support personnel
- Exceeding policies: stretching the term, LTV, rate or other conditions
- Appropriate approval authority

Detection Tools

Collection Department Input:

A significant tool to detect negative trends in the indirect loan program often overlooked is the value of the collection department to spot negative trends that can expose underwriting weaknesses or dealers that are submitting fraudulent information on credit applications

Collection Department Input:

- Well-trained collection staff will try to determine the reason for the delinquency
- Not uncommon that reason for delinquency is attributed to false information provided on borrower's credit application by the dealer

Detection Tools

Post Charge-off Review of Indirect Loans

Though not as pro-active or effective (because "after-the-fact") a periodic post charge-off review of indirect loans to determine if there are any patterns present should be part of any indirect loan program

- Generally will define commonalities in underwriting or problems with specific dealerships
- Generally results in findings that require further analysis to determine if any corrective action is needed

Questions to Ask when Performing Internal Audit of Indirect Lending Program

Questions to ask

- Does management use a log that includes:
  - Dealer name
  - Date received
  - Terms of the deal
  - Member name/account number
  - Eligibility
  - Loan officer approval/denial terms including stipulations
  - Elapsed time between receipt of the application and the call back

Questions to ask

- How are "new" member indirect loans processed, including:
  - Signature card
  - Membership fees
- How are loan officer's approval/denial and call back to dealer documented
- How are incoming loans verified to terms and conditions loan officer quoted to dealer and who performs this approval

Questions to ask

- Do you require dealers to submit a copy of dealer invoice with each loan
- Is verification or comparison of original collateral approved to collateral listed in indirect loan package performed to ensure collateral is same and contains same options
- Is member ever contacted to confirm options on the vehicle

Questions to ask

- Who performs computer input
- Who disburses
- How do you monitor approvals and denials by dealer
- How do you monitor indirect loan delinquency and charge-off by dealer
- How do you detect if staff are receiving compensation from dealers for loan approvals

Questions to ask

- How do you monitor approvals and denials by indirect loan officer
- How do you monitor indirect loan delinquency and charge-off by indirect loan officer
- Who has authority to override to approval on previously denied indirect loans

Questions to ask

- How are denied indirect loans that are overridden to approval monitored
- How is override of a previously denied indirect loan documented
  - In loan file
  - In data processing system

Risks and Pitfalls in Leasing

Leasing

- **Rules and Regulations – Part 714**
  - Permissible leasing
    - ◊ *Direct leasing – credit union purchases assets and leases to member*
    - ◊ *Indirect leasing – third party leases asset to member and credit union purchases lease to member*
    - ◊ *Open-end leasing – member assumes risk and responsibility for difference in residual value and actual value at end of lease*
    - ◊ *Closed-end leasing – credit union assumes risk and responsibility for difference in residual value and actual value at end of lease*

Leasing

- **Rules and Regulations – Part 714**
  - Must be a net lease – member assumes burdens of ownership
  - Must be full payout lease – reasonably expect to recoup entire investment in leased asset

Leasing

- **Compliance**
  - Regulation M – Consumer Leasing Act
  - Implements the consumer leasing portions of TIL Act
  - Has specific initial disclosure requirements that must be adhered to in the contract

Leasing

- **Risks**
  - Need written comprehensive loan policies and procedures on leasing
  - Most credit unions use third parties so many risks of indirect lending may also apply for leasing
  - Interest rate risk
  - Marginal income spreads

Leasing

- **Internal Control Risks**
  - Credit union bears credit risk on defaulted leases
    - ◊ *Residual value insurance does not protect you*
    - ◊ *Credit union responsible to repossess, sell and bear depreciation expense (loss)*
  - Competition
    - ◊ *Tempt you to offer lower lease payments by increasing residual values which may cause loss at end of leases*
  - Poor or no maintenance to vehicle by member may decrease value at end of lease
    - ◊ *Can penalize member but may be hard to collect*

Leasing

- **Internal Control Risks**
  - Losses from depreciation and inability to sell lease contract sole liability of credit union
  - Use of third-party to administer have risk of their failure and all monitoring and administration comes to credit union
  - Must have written agreements for vehicle dispositions with third-party or insurance company or run risk of being a used auto company

Leasing

- **Insurance Related Risks**
  - Does insurance policy
    - ◊ *Contain provisions for leasing*
    - ◊ *Ensure all financed leases are covered*
  - Residual value insurance
    - ◊ *Receive principal balance of loan upon fruition of lease term*
  - Gap insurance
    - ◊ *Protects from loss due to gap between insurance company's book value of vehicle and credit union's principal balance in case of stolen or wrecked vehicle*
  - Does management review the strength of the insurance providers (e.g. ratings)
    - ◊ *How often and how documented*

Conclusions

Conclusion

Rapid increase in loans can often bring with it problems which put pressure on underwriting standards, Collection Departments, and which increase liability issues and fraud occurrences

Conclusion

Implementation of adequate controls and the careful monitoring and consistent review of loans submitted by dealers to ensure loans are in compliance with loan policies, procedures and underwriting standards is essential in limiting risk and loss

Conclusion

Many credit unions have moved away or not instituted a leasing program due to all of the additional burdens of leasing – controls, administration, insurance, and financial loss

Bryan W. Mogensen, CPA
Partner
bryan.mogensen@cliftonlarsonallen.com
602-604-3551

CliftonLarsonAllen
cliftonlarsonallen.com

twitter.com/
CLA_CPAs

facebook.com/
cliftonlarsonallen

linkedin.com/company/
cliftonlarsonallen