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COUNTING ON SMOOTH SAILING?

A FEW KEY DECISIONS COULD CREATE CHOPPY WATERS

Protecting Against Subprime Lending Concerns

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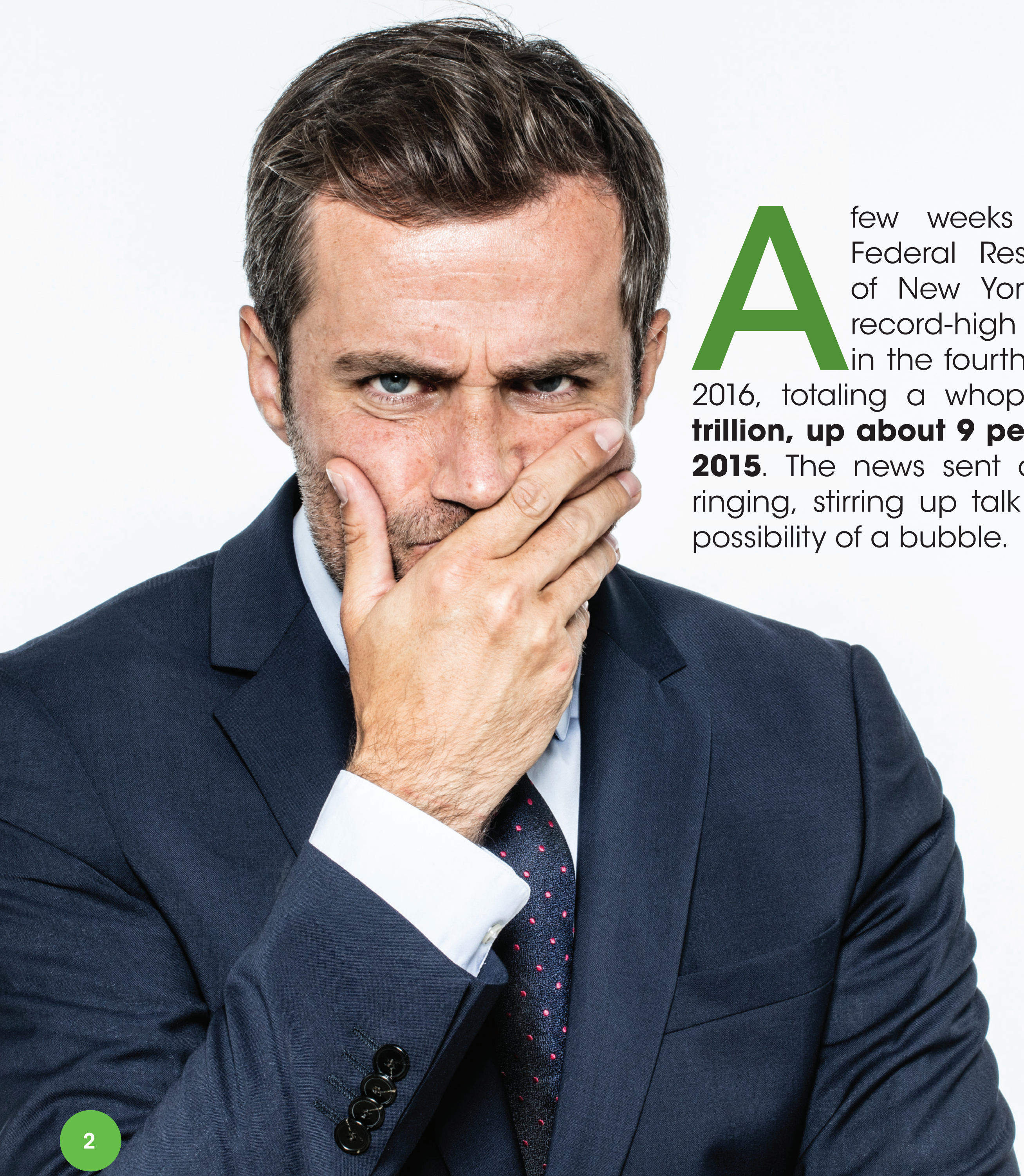

A few weeks ago, the Federal Reserve Bank of New York reported record-high auto debt in the fourth quarter of 2016, totaling a whopping **$1.16 trillion, up about 9 percent from 2015**. The news sent alarm bells ringing, stirring up talk about the possibility of a bubble.

Lenders and dealers alike should not panic, but certainly need to take notice. With the Great Recession over, consumer confidence has grown and spending is on the rise. Overall underwriting standards have loosened, and we've seen lower credit standards in the automotive space.

The report stated that about *32%* of auto origination dollars went to consumer buyers with credit scores over *760*. This is up from *696 in 2015*. It's also not uncommon for a buyer to finance a vehicle for up to six or seven years.

While more cars were sold in 2016 than ever before, what's worrisome is that many of these car buyers may not have a record handling finances well. In the subprime space especially, car companies and their finance units underwrite approximately three quarters of all car loans today. So, when delinquencies begin to rise beyond a slight uptick, those lending to subprime buyers will likely pay the price. And, according to the report, more than ***6 million consumers are at least 90 days late on car payments***.

While we can expect to see some tightening up of approval standards among lenders, there are some other steps lenders can take to protect their portfolios, continue to increase loan volume, and grow market share.

The use of consumer protection products, such as vehicle service contracts (VSC) or vehicle return protection, is one area that can help lenders differentiate from the competition and manage delinquency rates, and also provide an additional stream of revenue.

Consumer protection can especially be helpful when dealing with subprime buyers. Consider what would happen if a subprime consumer suddenly experiences a mechanical breakdown.

Do you think it is likely that this consumer could face paying for both the repair cost and the monthly loan payment? If you were that consumer, how would you prioritize?

Most likely, you would choose to fix the car so you can get to work, but the tradeoff is that your car payment will become late.

But by offering complimentary VSCs or other programs such as tire and wheel, paintless dent, or vehicle return protection, lenders can alleviate those costly tradeoffs for consumers, potentially protecting the loan from delinquency or default, and in turn, protecting the loan portfolio. VSCs can help reduce costly mechanical repairs to a manageable deductible, giving consumers the ability to repair their vehicle and make their payment.

With vehicle return programs, consumers receive protection against unexpected life events, such a job loss. Consumers can return their vehicles to the selling dealership without experiencing a negative impact to their credit – and saving lenders from costly repossession expenses.

Lenders offering these products also differentiate loans with dealers by giving them the ability to further increase dealership profit through the sale of upgrades, as well as gaining the confidence and loyalty of consumers who wish to protect their investments.

Mark Rappaport
President, Simplicity Division
Enterprise Financial Group

THE RAT RACE IS ON!

In 2016, we all held our breath to see how the presidential race would turn out, with everyone saying that those results would affect the economy. In the aftermath of President Trump's win, **we watched the "North Star" of the health of an economy** – the stock markets – and they rose, hopefully signifying good times ahead.

Nevertheless, the heated political atmosphere continued past 2016 and into 2017. Now, you can't listen to the radio, turn on the T.V., read a newspaper, or open a social media app without seeing articles about the current administration and whether or not it is successful. No matter if you are a Republican or Democrat, Trump or Clinton supporter, if you're a lender seeing these stories proliferate, it probably gives you pause on whether the economy can weather this storm.

According to the National Automobile Dealers Association (NADA), **U.S. new vehicle sales are expected to stay above 17 million in 2017**, roughly on par with last year's levels. On all accounts, it currently looks like we're still on track to meet those expectations. As a lender, you probably expect to receive roughly the same loan volume as you did last year. However, **economic factors like the heated political atmosphere could have lasting repercussions on your loan volume.**

Let's start with rising vehicle prices. Every year, vehicle prices rise as the cost of making a car rises. Under the current administration, it looks like manufacturing costs will increase more than in years past due to the potential disruption of trade agreements between the U.S. and Mexico, among other countries. **Depending on how much new vehicle prices rise, this could affect the general consumer sentiment around buying a vehicle this year**, thereby reducing the number of vehicle shoppers.

At the end of 2016, the Federal Reserve anticipated to increase interest rates three times in 2017. While they haven't instituted an increase yet, the Fed Chair, Janet Yellen, recently told Reuters that she expected the first interest rate hike of the year to take place at their next upcoming meeting.

With the combination of rising vehicle prices and interest rates, you, along with your peers, are most likely taking a hard look at subprime auto loans. **I would expect more lenders to continue reducing originations in that space, thereby shrinking the available pool of loans and creating a race for loan volume in the prime spaces**.

This will mean that lenders will need to step up their game with dealers to protect their dealer relationships and maximize their loan volume. And, don't think lenders are the only ones preparing for an unpredictable economy. Dealers will be looking to gain greater profitability from their F&I operations as part of their own preparations. As part of this effort, **expect dealers to re-evaluate their lender roster to make sure they are partnering with a broad spectrum of lenders** that specialize in the different credit tiers of their customer bases. In addition, dealers may take a hard look at their lender relationships in terms of what they get, and how lenders help them achieve their goals.

What does this mean for you? **Take a look at how your institution services dealerships**. Think beyond the basics of funding more than the cost of a vehicle to accommodate finance and insurance (F&I) products. Instead, think in terms of all the contact points your institution has with dealers beyond automatic approvals and denials.

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Choose:
COMPETE OR MANAGE RISK

Brien Joyce
VP, Specialty Channels
Enterprise Financial Group

Remember when you were shocked that average loan terms had increased to **62 months, then 68 months** and so on? While the industry is no longer shocked by loan terms that last more than five years, lenders are now grappling with the reality that their borrowers are upside down on their loans for much longer periods of time while still making record-high loan payments.

According to Experian's latest State of the Auto Finance Market report, the average new vehicle payment increased to **$506 in Q4 2016**, with an average loan term of **68 months** and an average amount financed of **$30,621**.

Within **68 months**, what do you think is the likelihood of a consumer experiencing something that would affect their ability to make their auto loan payment? Maybe their car breaks down or they lose their job. Your algorithms can probably tell you that the likelihood is pretty high. That's why Experian has seen **60-day delinquencies rise** in almost every State of the Auto Finance Market report issued in the past few years.

But, that's why you have tiered rate structures as a buffer against risk. The problem with relying solely on rate to protect your auto loan portfolio is it makes it more difficult to compete for a given group of consumers. That's why more lenders are evaluating options outside of rate to help mitigate risk.

One option that is growing in popularity is the use of strategic complimentary consumer protection products, like vehicle return protection or a vehicle service contract, such as complimentary limited powertrain protection. Products like these can potentially enable consumers to stay current on their auto loan payment when unforeseen circumstances occur, such as a vehicle breakdown or involuntary unemployment. This makes it possible for lenders to increase control and recoup more potential losses beyond setting a higher APR.

For example, based on aggregated claims data for 2016, **EFG found the average vehicle repair bill to be $937.83, just shy of $1,000**. Consider the struggle most Americans face when presented with a **$1,000 repair bill**, when they are already making a $506 auto loan payment. Could your budget take a **$1,500 hit?** What about your adult children's budget? The most likely course of action is for a person to choose one payment over the other. Consumer protection products enable customers to make a low deductible payment to get their vehicle back on the road and stay current on their auto loan.

As long as loan terms continue to lengthen and vehicle prices continue to rise, lenders need to fortify themselves against the risk of default and delinquency. By pairing the benefits of complimentary consumer protection products with a well-executed rate structure, lenders set their institutions up for materially reducing the risk of default while at the same time, adding value to the loan for both consumers and dealerships.

Consumer protection products address pressing consumer needs which, in turn, help dealerships demonstrate their commitment to their customers. Dealers offering your loans with complimentary consumer protection products also have the opportunity to further increase their bottom line through the sale of upgrades, as well as the potential to boost CSI scores and increase retention and referrals.

With more than 40 years of experience in developing market-differentiating consumer protection products, EFG Companies knows how to expand your market share while protecting your loan portfolio. Contact us to find out how today.

THE COST OF COMPLIANCE

Barry Carter
Chief Operating Officer
Enterprise Financial Group

Since July 2010, the Consumer Financial Protection Bureau (CFPB) has made significant waves in the auto finance space. In 2013, they issued their bulletin titled **"Indirect Auto Lending and Compliance with the Equal Opportunity Act"** stating that they would regulate lenders on unanticipated discriminatory practices. With very little guidance on how to be compliant, lenders and dealers scrambled to revamp their anti-discrimination practices to little avail.

Between 2013 and 2016, the CFPB filed 13 enforcement actions totaling upwards of **$165.17 million** against auto financiers, such as:

Beyond the restitution and civil penalties leveraged against lenders, the increased compliance oversight also had direct impact on dealer profit margins, consumer prices, and the national GDP.

According to a 2014 study of the auto finance regulatory environment by the Center for Automotive Research (CAR), regulations pertaining to employment, accounting and vehicle financing made up more than **63% of all estimated federal regulatory compliance costs**. The administration of vehicle financing alone accounted for **71%** of all vehicle finance compliance costs and **26%** of total dealership compliance costs.

In 2012, a typical U.S. dealership with ***$38 million* in revenue** incurred ***$182,754 annually* in federal regulatory compliance costs**, which amounted to:

- **21.7% OF THE AVERAGE DEALERSHIP'S BEFORE-TAX NET PROFITS**
- **$2,371 PER DEALERSHIP EMPLOYEE**
- **106 VEHICLE SALES**
- **$100 MEAN COST PER VEHICLE**

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Steve Roennau,
VP, Compliance
Enterprise Financial Group

ONLINE REVIEWS AND COMPLIANCE

Over the last few years, businesses everywhere have been working hard to establish a positive online presence beyond just their website. It's become standard practice for lenders to be listed on websites like consumeraffairs.com, lendingtree.com, and bankrate.com. The reason behind these listings is to build trust online and develop a brand presence.

After all, it would be extremely difficult to find an industry that hasn't been affected by the prevalence of consumers who conduct online research for products and services, including reviews, before making a decision. This tends to become more prevalent with services and purchases that could have long-term repercussions, including insurance, loans, credit cards, etc.

Now, you're probably asking yourself, what does this have to do with compliance?

In this highly integrated world of online reviews and social media, it can be tempting for lenders to use cookie cutter, online review vendors to boost positive reviews while minimizing negative reviews. For example, one widely used tactic across all industries is to utilize contract provisions, including online terms and conditions, to penalize consumers for posting negative reviews or complaints. This specific tactic has been ruled as illegal under the Consumer Review Fairness Act (CRFA), which protects people's ability to share in any forum their honest opinions about a business. Specifically, the CFRA makes it illegal for a company to use a contract provision that:

- bars or restricts the ability of a person to review a company's products, services or conduct;
- imposes a penalty or fee against someone for leaving a review; and that
- takes ownership of a person's review when they mention the company's name, thereby requiring people to give up their intellectual property rights of the content in the review.

The Federal Trade Commission and the state Attorneys General have the authority to enforce the CRFA. Any violation will be treated the same as violating FTC rules around unfair or deceptive acts or practices, meaning companies everywhere could be subject to financial penalties.

So, what can lenders do to ensure compliance? Start by reviewing your applications and/or legal paperwork to remove any provision that restricts people from sharing their reviews and/or penalizes them for doing so. Beyond contract work, it's best to take a common sense approach to consumer reviews.

Think about your own experience researching a product or service online. When looking at reviews, you can probably tell which reviews are fake. And, if a service has only positive reviews and no negative reviews, you probably find that a little hard to believe. The brands you are more likely to trust are the ones with a mix of positive and negative reviews, and who follow up with all reviews to thank them and resolve any issues. That is the approach you need to take with your own institution.

Think of it in three simple steps:

1. RATHER THAN TRYING TO FORCE A POSITIVE REVIEW, LET CUSTOMERS THINK ON THEIR EXPERIENCE SO THEY CAN GIVE YOU AN HONEST REVIEW THAT RESONATES MORE WITH YOUR CUSTOMER BASE.

2. STAY ACTIVE IN MONITORING REVIEW AND SOCIAL MEDIA SITES TO RESPOND TO REVIEWS IN A TIMELY MANNER.

3. RESPOND TO ALL REVIEWS, THANKING CONSUMERS FOR POSITIVE REVIEWS, AND REACHING OUT TO THOSE WHO POSTED NEGATIVE REVIEWS TO RESOLVE ANY QUESTIONS OR CONCERNS.

The key with negative reviews is to demonstrate a willingness to work with the customer, and to take the conversation offline. After a negative review is resolved, you can always ask the customer to update their initial review.

The goal is to build consumer advocates. By remaining consistent and active in your response to all reviews, it is possible to direct the conversation rather than react to it.

With more than 40 years of consumer insights and a dedicated NAF- and AFIP-certified Vice President of Compliance, EFG Companies can help you take a compliant approach to online reputation that generates a positive online brand experience. If you are ready to direct the conversation, contact us today.

EFG COMPANIES

THE COST OF COMPLIANCE
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This totaled **$3.2 billion** in compliance costs across all U.S. light vehicle dealerships, representing a **3.7% increase in dealership expenditures** and a **26% net profit decrease**. Even before the CFPB ramped up their compliance oversight, dealers were exploring every possible avenue to make up their lost profit margins due to compliance, including:

- **cutting their labor force;**
- **raising vehicle prices where possible;**
- **increasing unit sales volume; and**
- **increasing their F&I product penetration rates.**

Since then, compliance costs have only continued to increase, helping to further inflate new vehicle values, loan terms, and loss ratios. **This increased dealer and economic cost is taking a toll on loan portfolios.** As lenders look to protect themselves from rising delinquencies that have resulted from market inflation and aggressive lending standards, it's important that they also look at how to stay relevant and competitive in the market by helping dealers recoup their lost profit.

Lenders offering complimentary consumer protection products, like vehicle service contracts and vehicle return protection, have a three-fold advantage over the competition by providing benefits to consumers, dealers and lenders.

1. Benefits to Consumers: Consumer protection products allow consumers to avoid unexpected expenses that may inhibit their ability to make their car payment.

2. Benefits to Dealers: Starting the F&I process with a loan paired with complimentary consumer protection products puts dealers in a positive position with their customers, enabling them to upsell consumers to enhanced benefits, thus improving profit potential.

3. Benefits to Lenders: Consumer protection products have the potential to differentiate a lender from the competition by providing benefits consumers want and profit potential dealers need. They also protect lender portfolios from the risk of default and delinquency by protecting consumers from unexpected expenses. Lastly, lenders have a greater ability to pad their portfolio with non-interest bearing income.

As compliance costs and vehicle prices rise, lenders need more tools than APR and loan terms to manage look-to-book goals and loss ratios. Adding complimentary consumer protection products to their tool belts opens the door to increased non-interest-bearing income, better dealership relations, and enhanced compliance control.

EFG® COMPANIES

With 40 years of innovating and implementing proven go-to-market strategies in the dealership space, EFG Companies understands the balance between ensuring complete compliance and building profit margins. That balance lies in the value proposition. Which is why EFG structures its products and services to not only provide value to you, but also dealerships and the end-consumer. Our unmatched client-engagement model goes well beyond simple product innovation to mitigating liability through superior claims processes, and continuous training and auditing practices. Contact us today to fortify your loan portfolio, increase your profitability, and expand your dealer book of business.

THE CO$T OF COMPLIANCE

How you apply the principles of compliance directly affects the overall cost of compliance to your business.

A typical U.S. dealership with revenue of

$38,000,000

incurred an annual average cost of

$182,754

in federal regulatory compliance costs.

These costs amounted to:

21.7%	of the average dealership's before tax net profits
$2,371	per dealership employee
106	vehicle sales
$100	mean cost per vehicle

This totaled 3.2 billion in compliance costs across all U.S. light vehicle dealerships

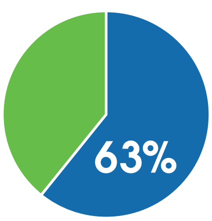
It also represented a **3.7%** increase in dealership expenditures:

↑ **3.7%** increase in expenses equates to a ↓ **26%** net profit decrease

to make up that profit, dealers would need to increase vehicle prices ↑ **3.2%**

NUMBERS AT A GLANCE

Regulations pertaining to employment, accounting and vehicle financing make up more than **63%** of all estimated federal regulatory compliance costs:



Federal regulatory compliance costs

- employment
- accounting
- vehicle financing

The administration of vehicle financing accounts for **71%** of vehicle finance compliance costs and **26%** of total dealer compliance costs.

Vehicle regulations governing safety emissions make up **21.5%** of dealer compliance costs.

OVERALL IMPACT

↓ **$441,332**

Dealerships lost an estimated **$441,332** worth of net business & economic activity due to federal regulatory compliance costs.

$7.7B / ↓ **10,550**

This resulted in an estimated economic cost to light vehicle dealerships of **$7.7 billion**, and a **10,550 reduction** in direct dealership employment.

↓ **$10.5B**

Overall impact to U.S. economy is estimated at **$10.5 billion** in lost economic output.

Contact EFG today to cultivate a profitable culture of compliance.

How often do you sift through denials to determine if they could have been approved with more information?

When a loan application is flagged as incomplete, is it automatically denied, or does someone get on the phone with the dealership to keep the contract moving?

How often do your loan managers set up in-dealership meetings to collaborate on the management of look-to-book, contracts-in-transit, and discuss changes to credit qualifications?

Lastly, how are you helping dealers maximize their profit opportunity on every closed loan? The more options you provide dealers to increase their profit margin in a compliant manner, the more likely they are to choose your loans. This can be accomplished by providing complimentary consumer protection products, like vehicle service contracts or vehicle return protection, on your loans.

Providing complimentary products helps set the stage for F&I managers to upsell customers to enhanced or expanded coverage, making it possible to increase your margins in addition to the dealership's PRU.

In 2017, the name of the game for loan volume will be taking a holistic approach to dealer relationships. Those lenders that make dealer goals a priority will be well placed to increase market share. With more than 40 years of experience helping dealers achieve their profitability goals, EFG knows how to position lenders for success in the retail automotive space. Contact us today to cultivate a mutually beneficial relationship with your dealer partners.

EFG Companies Fortifies Dealer and Lender Data Security Through SSAE 16 SOC 1 Certification

AICPA Service Organization Control Reports

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Formerly SAS 70 Reports

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