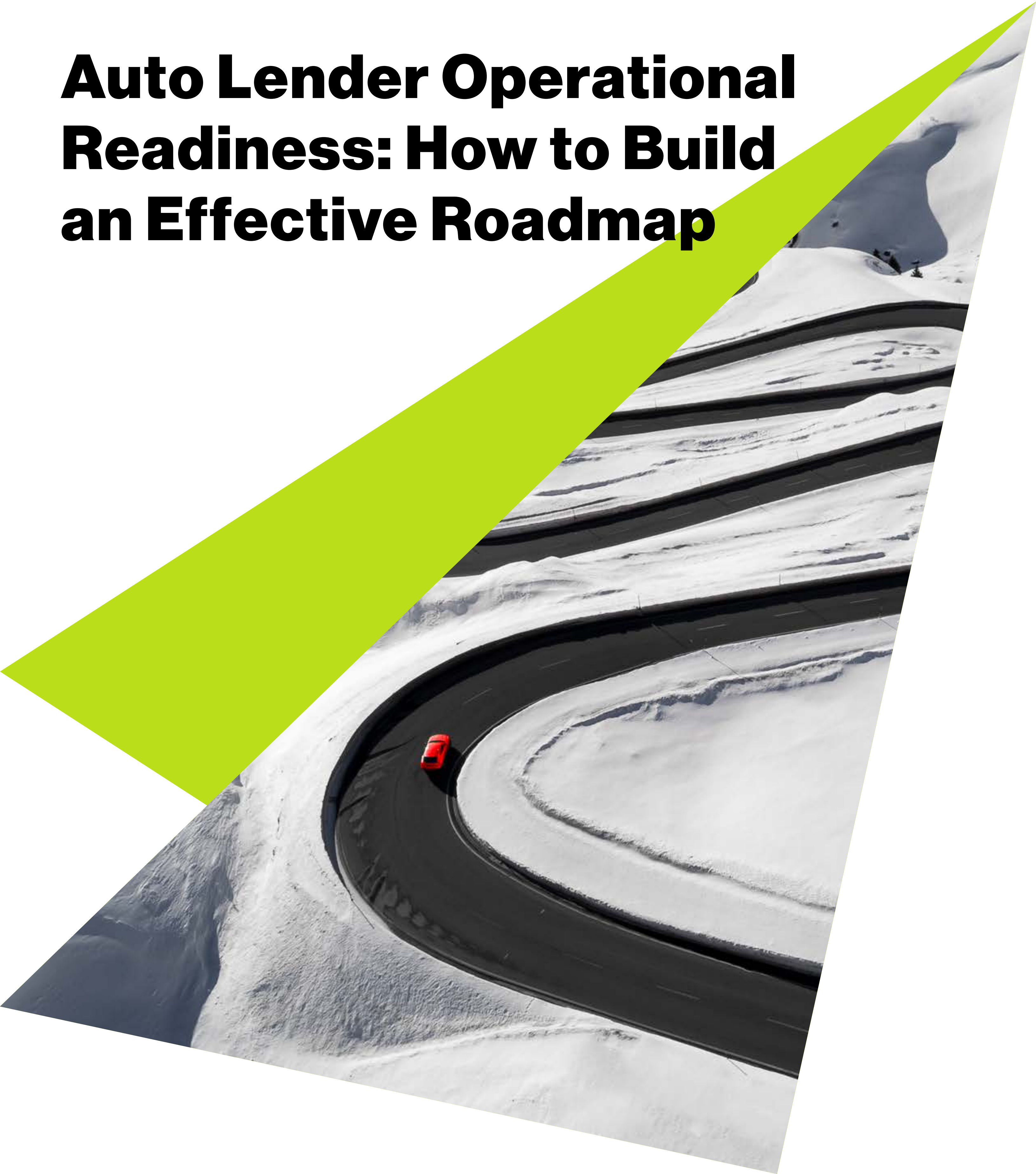
Auto Lender Operational Readiness: How to Build an Effective Roadmap



Financial Services

Auto Lender Operational Readiness: How to Build an Effective Roadmap

Preparing for a Changing Paradigm

As economic indicators softened in 2019, the auto industry began forecasting an uptick in credit risk and delinquency rates. In 2020, with the financial impact of the pandemic, the landscape for lending suddenly changed. With an influx of stimulus cash and large government protection programs, an adverse risk environment was effectively deferred.

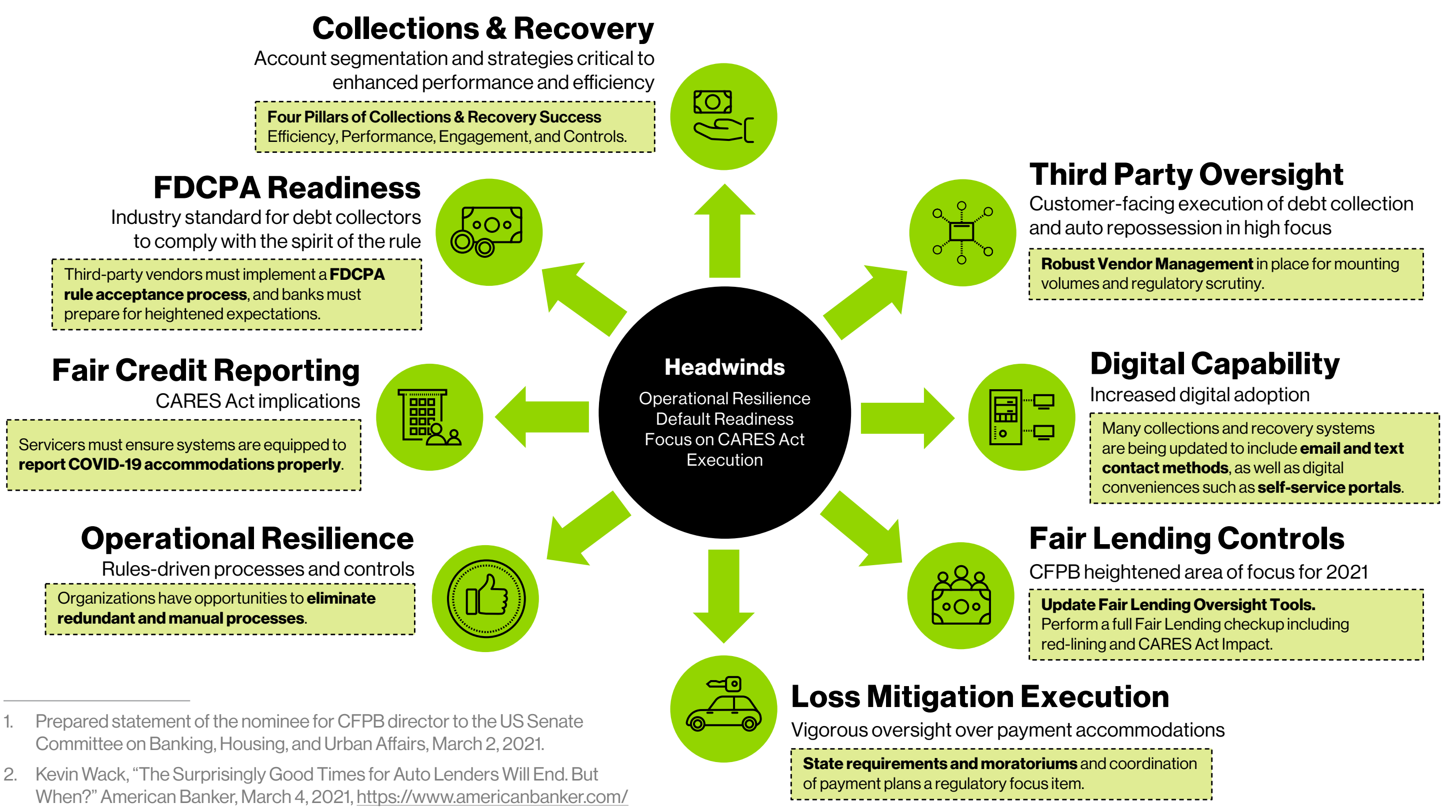
A portfolio risk "bubble" is now deferred even further with the $1.9 trillion pandemic relief plan, which was passed in March 2021. While the economy has shown signs for recovery, "experts expect distress across a number of consumer credit markets, including an avalanche of loan defaults and auto repossessions," according to Rohit Chopra, President Biden's nominee for director of the Consumer Financial Protection Bureau (CFPB).[1] The auto lending industry is still rationalizing the current environment, with the majority of large banks expected to loosen their underwriting standards in 2021, with few intending to tighten standards, per a Federal Reserve senior loan officer survey. There is reason for optimism, but it is possible we have not seen "the full impact in terms of defaults and credit losses."[2]

As such, auto lenders should prepare for any material increase in delinquency, repossessions, and charge-offs. This readiness will occur against a backdrop of increasing regulatory scrutiny and active enforcement, as signaled by the Biden administration.

For the remainder of the year, we expect three dominant forces to hold the attention of the auto lending space:

- Duration of the pandemic vs. the impact of the relief protection programs
- Timing and proportion of auto defaults and repossessions
- Heightened regulatory scrutiny under the Biden administration

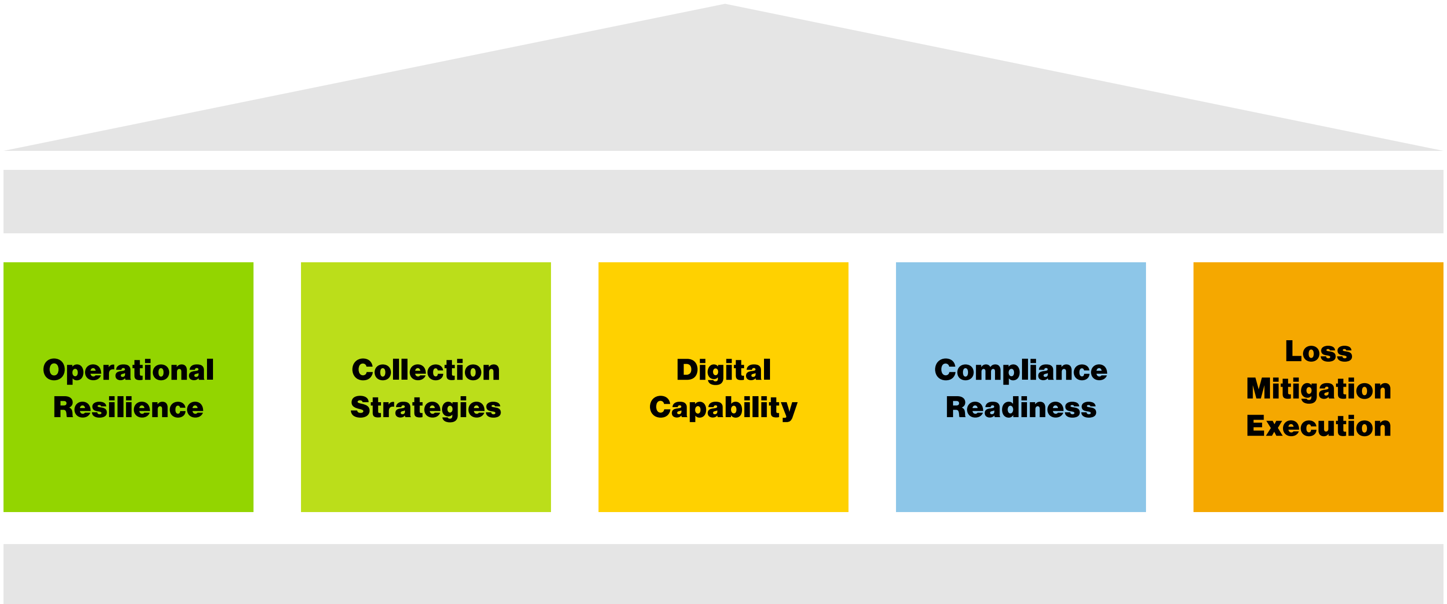
To prepare for these trends, auto lenders should examine the operational, compliance, and technological underpinnings of their operations (Figure 1). This means industry leaders should act now to maximize performance, profitability, and controls.



1. Prepared statement of the nominee for CFPB director to the US Senate Committee on Banking, Housing, and Urban Affairs, March 2, 2021.
2. Kevin Wack, "The Surprisingly Good Times for Auto Lenders Will End. But When?" American Banker, March 4, 2021, https://www.americanbanker.com/news/the-surprisingly-good-times-for-auto-lenders-will-end-but-when.

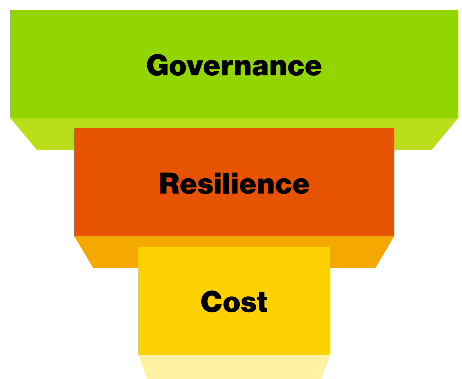
The Readiness Checklist:

To address these challenges, industry participants should focus on the following five major pillars of readiness:



1. Operational Resilience

The Biden stimulus plan will likely extend the suppression of delinquency. This expected lull in delinquencies affords auto finance organizations precious, but limited, time to prepare for spikes in default volumes.



The focus during this timeframe should be on preparing for optimal processes and implementing updated technologies. There are abundant opportunities in many shops to scale operations by eliminating redundant or manual processes that create operational and reputational risks and burn costly labor hours.

Having deficient delivery mechanisms in a heightened regulatory environment could be disastrous, particularly if delinquencies begin to spike. The pressure placed on collections and servicing is predicted to continue well into 2022. As a result, robust rules-driven processes and controls, and updated collections systems and digital conveniences for customers, become imperative.

2. Collection Strategies

Effective and efficient collections in today's environment means incorporating sophisticated segmentation strategies and contact techniques to maximize the intrinsic value of an auto portfolio. Lenders should consider distinct demographic differences among troubled borrowers. For example, 61% of debtors with annual incomes of less than $35k were affected by the pandemic, and of that group 57% missed at least one payment. Lower-paying jobs are most likely to be affected, with retail (27%) and nonessential retail (58%) most adversely impacted.[3] Understanding and reacting to these demographic differences in risk and contact strategies will likely produce better file penetration and solutions.

Leaders Will Modernize Collection Strategies

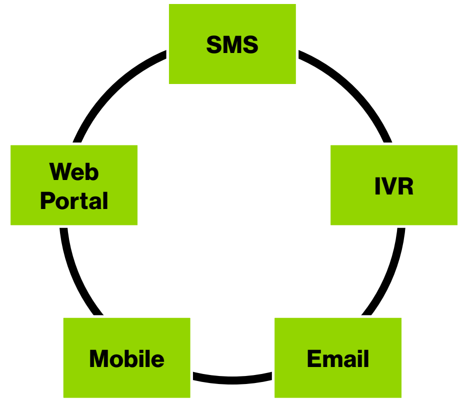
- Data Capture & Analysis
- Account Tracking
- Escalations
- Complaint Management

Many firms are examining ways to drive strategy through tying account treatment to customer behaviors using machine learning and AI. For example, matching communication preferences to certain digitally native cohorts could put lenders in a better position to optimize collection performance.

3. Cox Automotive, "COVID-19 Consumer and Dealer Impact Study (April 3–September 18, 2020)," https://www.coxautoinc.com/wp-content/uploads/2020/09/Cox-Automotive-COVID-19-Consumer-and-Dealer-Impact-Study-Summary-09-22-2020.pdf.

3. Digital Capability

The auto loan industry is undergoing a digital transformation in originations, servicing, and collections. Long term, all facets could operate within a digital ecosystem. With the pandemic, it has been said that digital adoption in loan originations, servicing, and collections was accelerated by at least five years. Text, email, and self-service portals are increasingly viewed by borrowers and regulators as a requirement to do business. Enhanced digital capabilities will support auto lenders in connecting with more customers, at a lower cost. This transformation is increasingly driven by innovative technologies developed by fintech companies partnering with captives and banks to drive traffic, sales, and service.



SMS – Short Message Service
IVR – Interactive Voice Response

For account servicing and collections, traditional methods of phone contact are yielding diminishing returns, and call blocking has become widespread, so lenders are working on alternative methods of reaching customers.

From a regulatory perspective, the CFPB has signaled to debt collectors and the creditors who oversee them, that debt collection should move away from traditional phone contact in favor of email and text in the new Fair Debt Collection Practices Act (FDCPA). Lenders should actively develop or accelerate their digital roadmaps and contact options should be effectively aligned to account segmentation strategies along with robust enterprise consent management tools and processes for customer opt-in and opt-out.

4. Compliance Readiness

FDCPA Rule Change Management

The CFPB issued a final rule to revise Regulation F, which updates the FDCPA. The rule specifically applies to third-party debt collection and prohibits harassment or abuse, false or misleading representations, and unfair practices in debt collection, and it is considered industry standard for banks to comply with the spirit of the rule.

It would be prudent for lenders and third parties to adopt an FDCPA rule acceptance process as soon as possible, including testing routines to validate debtor communications, technology changes, and practices and protocols required under the new Final Rule.

It is expected that financial institutions have until January 29, 2022, a newly proposed delay of 60 days compared to the originally proposed effective date of November 30, 2021, to install the provisions of the rule internally and to validate installation with their third-party agency partners.

In a New Compliance Regime, Market Leaders Will

- Assess internal and third-party risk.
- Move to less invasive contact methods.
- Take a multichannel approach.
- Implement new compliance controls

Third-Party Risk Management

Auto finance companies should set clear expectations for their third-party vendors through the issuance of service-level agreements and data reporting to ensure there is adequate oversight of their auto-servicing, technology processes, and customer communications. It will likely be imperative for third parties to manage breakdowns in customer communication; put systems in place to capture customer data and documents; and track, escalate, and respond to customer complaints.

We believe regulators will likely be paying close attention to the adequacy of vendor management systems to effectively categorize customer complaint metrics and track the dispute-resolution cycle. Additionally, we anticipate an intensified focus on default and repossession processes, including repossession forwarders and accurate notices of default.

Lender-Dealer Liability

Lenders should consider their oversight over dealers they work with. The expectation is that the CFPB will also pay close attention to lending practices carried out by car dealers, and whether they violate fair-lending requirements of the Equal Credit Opportunity Act (ECOA) and Regulation B. The concern is over indirect auto lenders that permit dealers to increase consumer interest rates and that compensate dealers with a share of the increased interest revenues. In the past, these actions have resulted in pricing disparities based on race, national origin, and potentially other prohibited bases.

Detective controls that monitor key fair-lending triggers, and are tied to an operational and compliance dashboard, are optimal. Complaint analysis and resolution is important, and more so now with a specific focus on fair-lending practices.

Ancillary Products

Ancillary products have been the source of regulatory scrutiny over the past few years and were mentioned in three consecutive CFPB supervisory highlights. The primary issues cited are around proper and timely processing of Guaranteed Asset Protection (GAP) insurance payments and cancellations.

Examples of deficiencies cited by the bureau include billing statements showing paid-ahead status in error after applying insurance proceeds incorrectly; unfair and deceptive practices regarding rebates for certain ancillary products where the lender used the wrong mileage amounts to calculate the rebate for extended-warranty cancellations, thereby overstating the deficiency balances; and abusive acts or practices when selling add-on GAP products specifically—examiners observed that lenders sold a GAP product to consumers whose low loan-to-value meant that they would not benefit from the product.

To address this, lenders should focus on three areas:

1. **Data Integrity**: Data that lacks consistency from input to output, i.e., inappropriate values in fields related to proper balances and beginning mileage. System errors have been considered Unfair, Deceptive, or Abusive Acts or Practices violations in regulatory exams.
2. **Process Design**: Minimal or incorrect process design may lead to inaccurate procedures and workflows. Disconnected processes or downstream implications may not be considered leading to unintended consequences (i.e., bankruptcy, credit reporting).
3. **Process Oversight**: Procedures are outdated, and reference dated or incomplete regulatory or state guidance. Process maps do not adequately reflect what is taking place and are lacking risk and control points.

Fair Credit Reporting

Servicers must comply with all credit-reporting regulations to avoid regulatory and litigation actions resulting from noncompliance with the Fair Credit Reporting Act (FCRA) and the Coronavirus Aid, Relief, and Economic Security (CARES) Act.

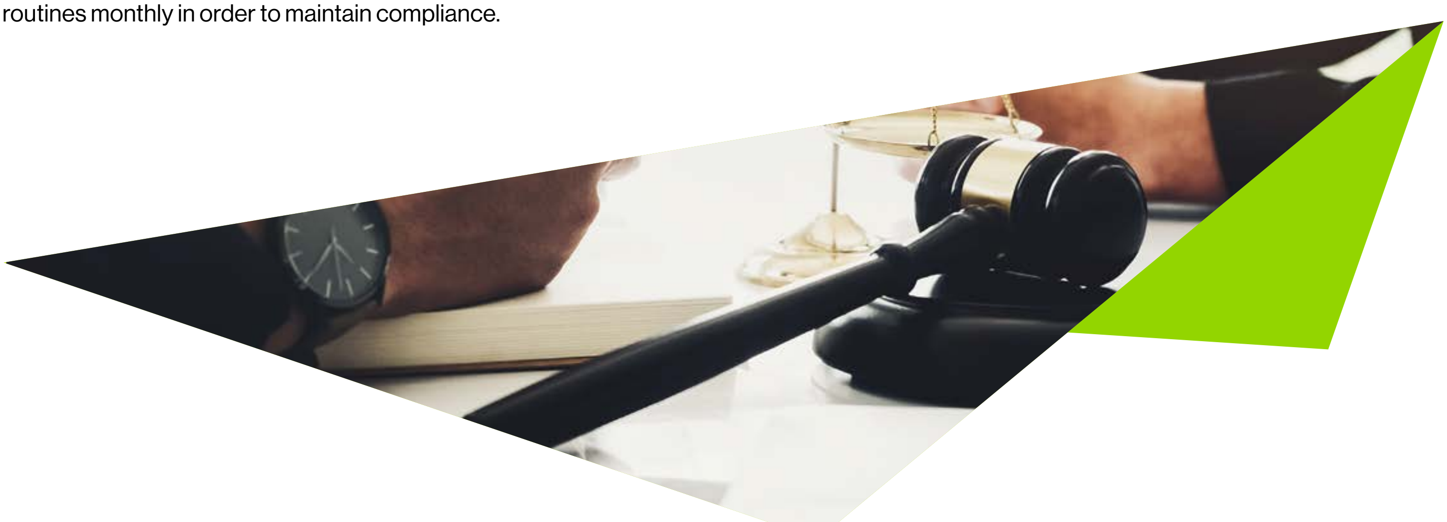
The FCRA was amended by the CARES Act last year; lenders who make a payment accommodation for a consumer because of COVID-19 are required to follow specific guidelines for accounts current versus delinquent at the time of a payment accommodation.

Servicers need to be aware of changing state and federal regulations to ensure policies, procedures and processes, and reporting are aligned with regulatory requirements. Additionally, servicers need to ensure their systems are equipped to comply with new regulatory requirements.

Auto servicers will likely be best positioned by determining the appropriate reporting approach based on existing systems to correctly report COVID-19, and conducting a review of Metro 2® files to validate that the data in the servicing system for borrowers with COVID-19 accommodations are appropriately reflected in the file and ensure alignment with the CARES Act. Automated tools are now widely deployed that perform quality control and assurance routines monthly in order to maintain compliance.

New Employee Training Requirements

- Metro 2® Files
- Disputes
- Reporting
- Data Privacy
- New Systems



Fair Lending

Fair Lending is a stated point of emphasis at the CFPB now. It's expected that the Biden administration might pivot to a targeted focus on auto underwriting and the methodologies that drive it. Chopra has signaled strong support for disparate impact analysis testing to detect discrimination in lending. The CFPB's enforcement of the ECOA will likely be emphasized as well in enforcement actions in the future. Acting CFPB Director Dave Uejio had also prioritized fair-lending enforcement and stated that he would "elevate and expand existing investigations and exams and add new ones to ensure we have a healthy docket intended to address racial equity."[4]

Given the uncertain economic outlook and the disproportionate impact the COVID-19 pandemic has had on a subset of borrowers, lenders should ensure that proper systems and controls are in place to comply with fair lending and other consumer protection laws. Auto lenders should focus on installing or updating preventive controls—including updated policies, procedures, and oversight, as well as risk assessments or underwriting practices of existing and new products in the auto space.

5. Loss Mitigation Execution

How well auto lenders establish, execute, and measure the success of their pandemic response to customer accounts will continue to be a focus of concern. Lenders should inspect their protocols and practices in the following heightened areas of regulatory focus:

Payment Accommodations

Proper execution of payment accommodations, credit reporting, and fair lending is expected to be a central priority in regulatory examinations.

Lenders can prepare for proper execution by evaluating the adequacy of existing delivery and response protocols in collections call centers and determining whether the correct status is recorded in host and collections systems. As deferrals expire, lenders should ensure consistent application of loss-mitigation treatment is applied throughout the portfolio.

With payment accommodations, lenders should disclose information to consumers, such as the amount of interest accrued during the deferment period or an estimate of the final payment amount, to allow consumers to budget and plan for the larger payment amount due at the end of their deferment period.

Repossessions

Auto repossessions will continue to be scrutinized as auto loans come out of first- and second-wave payment accommodations and enter default in 2021.

If an account must be assigned for repossession, lenders should act now to evaluate operational practices assessing whether they are consistently applied throughout all phases of the process—including whether the repossession decision, timing of assignments, and the number and amount of payments due are accurately reflected in debtor communications and in host systems.

In one case, a servicer sent borrowers notices warning them of possible repossession when, in fact, the servicer had suspended repossession operations during the time period per the 2021 CFPB Supervisory Highlights.[5] Wrongful repossession was highlighted in one recent enforcement action by the bureau and is certain to receive even more attention.

4. Dave Uejio, "The Bureau is taking much-needed action to protect consumers, particularly the most economically vulnerable," CFPB, January 28, 2021, https://www.consumerfinance.gov/about-us/blog/the-bureau-is-taking-much-needed-action-to-protect-consumers-particularly-the-most-economically-vulnerable/.

5. CFPB, "Supervisory Highlights COVID-19 Prioritized Assessments Special Edition," January 2021, https://files.consumerfinance.gov/f/documents/cfpb_supervisory-highlights_issue-23_2021-01.pdf.

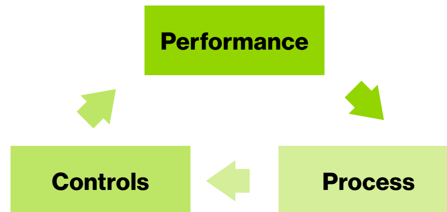
What Now?

Determine Your Organization's Readiness

Preparing your organization for the anticipated headwinds caused by the COVID-19 pandemic will be critical in supporting lending, servicing, and collections operations. While the pandemic has shifted priorities, there is an opportunity for auto lenders to strengthen operations, advance technology systems, optimize collections strategies, and increase readiness for an evolving regulatory landscape. To prepare for these risks, lenders should strive to establish a strong foundation now to be prepared for rising consumer defaults, heightened regulatory oversight, and other macroeconomic risks.

How Guidehouse Can Help

Guidehouse has a wealth of experience working alongside lenders to identify and implement solutions that yield high returns and competitively position organizations for success in the future. Leveraging deep subject matter expertise, our team has worked with partners to improve process, performance, and controls in the collections space. We've also partnered with our clients to optimize their readiness for regulatory and compliance examinations and actions. We provide organizations with in-depth analysis and assessments of current processes based on comprehensive knowledge of best practices. Our unique engagement model enables the participation of seasoned industry leaders to guide our clients to realize short- and long-term value.



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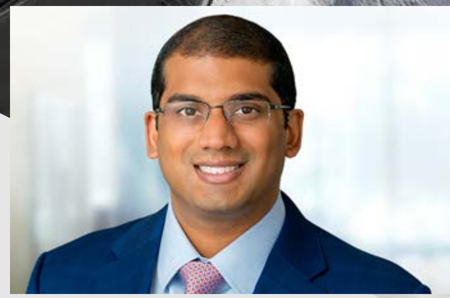

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About Guidehouse

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