MK&A®

THE DEALER VALUE PROPOSITION

Key Opportunities to Increase Relevance in Credit Union Indirect Auto Lending

Special Publication for
Attendees of DRIVE '17

CU DIRECT™

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CHANGES ARE COMING TO AUTOMOTIVE RETAIL: LENDERS TAKE NOTICE!

The next three years will bring changes for the automotive retail industry. Manufacturers, dealers, and lenders will have to adjust to a new car market that has no growth, or more likely, declining sales.[1] Shrinking sales will pressure dealer profit margins further as dealers are caught between their manufacturers' rising wholesale prices and the increasingly competitive sales market. Dealers will be forced to find other profit sources – or reduce expenses.

As the digital commerce trend continues to grow and dealers aim to reduce costs, lenders too will be swept up in the changes ahead. Dealers may partially eliminate the traditional finance office and reduce the role of finance and insurance ("F&I") manager discretion for funding approval and placement.[2] Conversely, dealers may place a larger emphasis on "backend" F&I grosses to counteract digital innovations that improve sales efficiencies but lower "frontend" margins. Finally, the drop in new car sales will result in used car sales becoming a more important high turnover profit center for dealers.

HOW DO THESE FORECASTED CHANGES AFFECT NON-CAPTIVE AUTO LENDERS?

Auto lenders must improve the speed of their operations.

Ranging from auto-decisions to quicker funding, lenders must improve the pace of transaction times for both their frontend and backend transactions.

Auto lenders must embrace technology and transparency.

Lenders must provide compatible technology solutions to assist their dealer partners and should expect in-dealership e-commerce platforms and mobile apps to become more common. Moreover, the role of lender-based automotive shopping sites and data-driven direct marketing initiatives will bring change to the auto shopper funnel and related lender loyalty.

Auto lenders must prepare for increased subvention by captive finance companies, especially for new and CPO units.

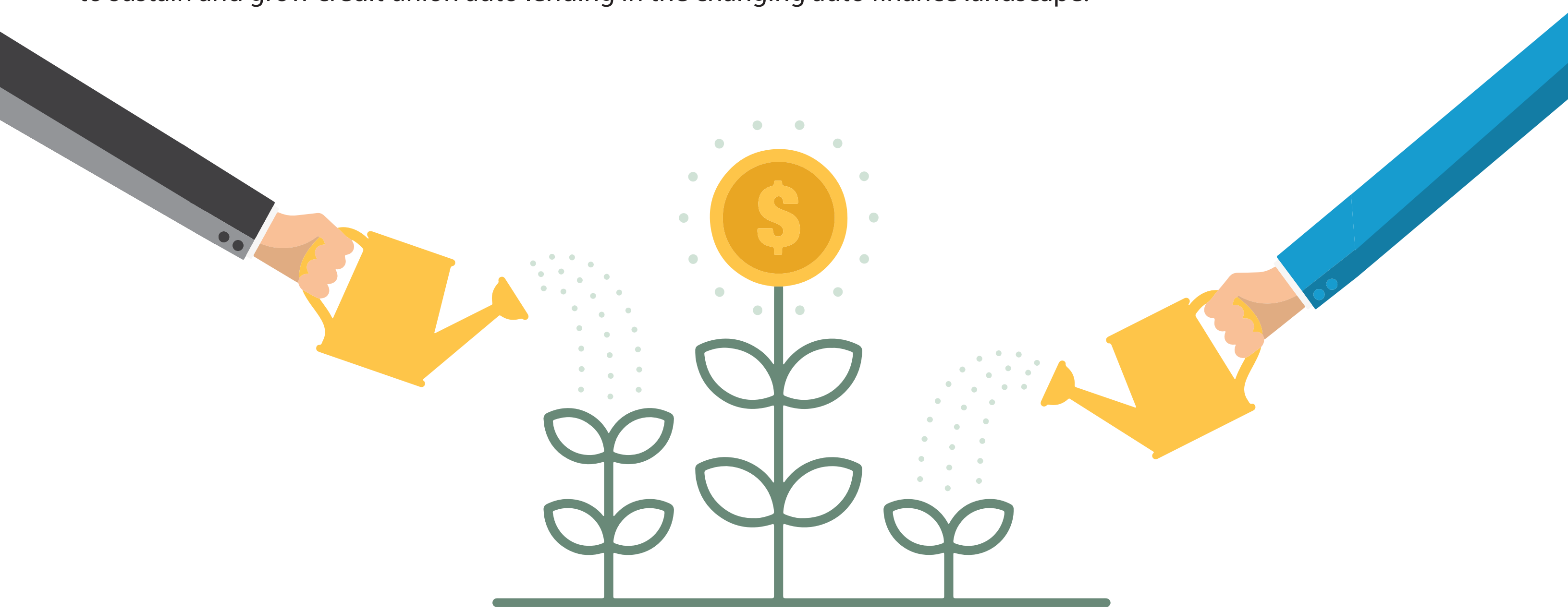
Captives will be more active in used cars by using subvented programs to help dealers transact on certified used vehicles. As a result of the captive's increased subvention of new and used car loans, non-captive lenders will be forced to be more aggressive with their lending programs. They can achieve this by experimenting with programs like extended loan terms, dealer incentives, and other novel approaches.

[1] http://www.detroitnews.com/story/business/autos/ford/2017/05/02/april-auto-sales/101192324/
[2] http://www.autonews.com/article/20160629/FINANCE_AND_INSURANCE/306299994/echopark-f%26i-process-to-echo-across-sonic

CREDIT UNIONS CANNOT SOLELY RELY ON LOW-COST APRs AND DEALER FLATS TO REMAIN COMPETITIVE.

Credit unions are currently competitive with other lenders. For credit unions participating in CU Direct's network, the average flat compensation fee was $450, or 1.76% of the average $25,600 contract amount, for both new and used car loans.[3] In comparison, while there is no official measurement of the typical dealer's reserve compensation from conventional lenders, a 2014 study commissioned by the American Financial Services Association, or AFSA, indicated dealer reserve ranges from $579 to $980 for non-subvented, prime loans (i.e. 680+ Fair Isaac Corporation "FICO" Score) from large non-captive lenders.[4] Several factors influence this range, including the loan amount and FICO credit score. Other sources place the average dealer reserve in the range from $650 to $750. In either case, both dealer reserve ranges are still more than the $450 offered by credit unions – even when adjusting for the total loan amount.[5] However, while credit union compensation is lower, credit unions, unlike most lenders, provide the added benefit of not charging back dealers for early loan payoffs.

The most important and tangible competitive attribute of credit union indirect auto lending is the current trend of lower borrowing rates for consumers. The average credit union rate is over 100 basis points less than traditional auto lenders.[6] This lower rate reduces the interest paid and thus reduces a customer's monthly payment; this may allow dealers more room for gross profit and sales of ancillary F&I products. Therefore, while credit unions don't offer dealers the highest explicit compensation for each referred indirect loan, they remain competitive due to a variety of favorable lending attributes. However, dealer compensation is not a sustainable advantage for credit unions, other strategies are necessary to sustain and grow credit union auto lending in the changing auto finance landscape.



[3] CU Direct Advisory Services. March 2017.
[4] "Fair Lending: Implications for the Indirect Auto Finance Market."Arthur P. Baines and Dr. Marsha J. Courchane. November 2014.
[5] http://www.autonews.com/article/20150413/FINANCE_AND_INSURANCE/304139983/some-dealers-prep-for-flat-fees
[6] CU Direct Advisory Services. March 2017.

CREDIT UNIONS MAY BENEFIT FROM THE BROADER AUTO LENDING INDUSTRY'S CONTINUED (ALBEIT SLOW) MOVEMENT TOWARDS FLATS.

Even with the Trump administration's threat of eliminating the CFPB, and therefore the agency's campaign to eliminate dealer discretionary loan markups, the industry's movement towards restricted dealer compensation continues as part of a broader trend in auto finance. While this may seem like a boon for credit unions, it's important to understand that flat compensation methods haven't reached critical mass yet. Flat compensation methods continue to gain traction, not only because of regulatory pressure, but also from external forces like internet initiatives from e-commerce focused dealers, third party websites, and even direct lenders.

Because of these shifting trends among all lender types, dealers now have more accepting views of flats than they did five years ago. This acceptance will only grow as variants of flat compensation continue to become more prevalent in auto lending. Ultimately, credit unions will benefit as their current compensation methods increasingly become the industry norm.

IDEA!

On average, the credit union auto lending rate is 100 basis points less than competing lenders. As Michael Cochrum, CU Direct's vice president of advisory service explains, many credit unions can add small basis points rate increases to their lending rates, therefore improving lending profitability while still charging less than their lending competitors.

HOW CAN CREDIT UNIONS BRING MORE VALUE TO INDIRECT DEALERS AND INCREASE COMPETITIVENESS?

Below, we provide seven opportunities for credit unions to both enhance exiting value and create new value for indirect dealer partners. We base these opportunities on our understanding of the current auto retail market, predictions for the near-term future, and collaborative research efforts with CU Direct.

OPPORTUNITIES TO PROVIDE MORE VALUE TO DEALERS...

1. ASSIGN DEDICATED PERSONNEL TO THE INDIRECT PROGRAM.

Dedicated personnel are a critical component of a credit union's successful indirect program. That's because a successful indirect program requires significant human capital resources internally, and externally, dealers prefer the convenience and efficiency of a devoted contact to address matters related to their lending relationship.

An indirect lending program requires staff to regularly monitor, develop, and support the initiative. Dedicated staff can efficiently monitor daily and automated internal reports and third party data for any variances. This can alert the credit union to any alarming risk trends, underperforming areas, or even overlooked opportunities. Staff should also assist dealers with operational support, ranging from approving deals to verifying funding. Finally, dedicated staff should proactively market business development programs to dealers, such as joint-sponsorship opportunities or affinity marketing programs.

The fast-paced nature of automotive retail, combined with the large dollar transaction amounts, forces dealers to seek lenders that can match their speed of doing business. Having a strong team in place to provide exceptional support can elevate the credit union's long-term relationship with dealers and enhance the quantity and quality of deals.

BEST PRACTICES

- Create pay-plan incentives for dedicated staff that promote the program's goals.
- Manage risk daily by using CU Direct's Lending Insights product to monitor critical indicators. (e.g. dealer's LTV, delinquencies, etc.)
- Focus on business development by working closely with dealers to monitor lending performance, spot opportunities, and engage in joint-marketing activities.
- Maximize the value of local relationships by demonstrating how the credit union's local proximity can provide dealers with superior support.

IDEA!

One highly successful Texas-based credit union places a major focus on maximizing its relationship with the dealership's staff. To this end, the credit union holds an annual and well-known dealer golf outing where they give away nearly $50,000 in cash prizes. Dealer principals, general managers, controllers, and F&I managers are invited to this annual event which successfully promotes dealer loyalty for the credit union.

2. USE INSIGHTS TO BUY DEEPER AND SMARTER.

Some well-known conventional lenders are contracting, not adding to, their loan portfolios while auto loan terms are becoming shorter, due in part from delinquencies and declining used car values. In light of worsening market conditions, many dealers are experiencing an increase in declined applications as auto lenders pull back. Consequently, credit unions must face the reality that they must weigh attributes other than FICO scores in order to approve future deals. Not only will this enable them to maintain their risk appetites but it will also yield new lending opportunities.

Despite their prominence in lending, FICO scores do not provide a complete depiction of a borrower's ability to repay an auto loan, since it is a one-dimensional view of risk that ignores other potentially relevant factors. Yet many credit unions base their approval decisions solely on FICO scores and vehicle attributes, therefore missing an opportunity to use advanced analytics and internal data to expand their risk spectrums safely.

To predict future loan performance more accurately, credit unions must utilize analytics that weigh more variables and credit attributes. These data will not only help the credit union pick up additional loan volume, but they'll also offer a credit union access to more profitable loans within their risk appetite. While credit unions are careful lenders that statistically have the lowest auto lending defaults in the industry, they could be leaving "money on the table."

BEST PRACTICES

- Select third-party data services and fintech algorithms to process additional attributes to gauge a potential loan's risk, such as those offered by CU Direct's Advisory Services.
- Regularly monitor portfolio performance via CU Direct's Lending Insights product. Review automated reports and related analytics that can spot trends and opportunities.
- Improve loan margins by offering higher rates to lower FICO segments while maintaining risk appetite as a result of weighing non-FICO credit attributes.

3. EMBRACE THE AUTO-DECISIONING PROCESS.

On average, credit unions only system decision 12% of indirect loan applications, a low percentage when compared to the overwhelming majority of conventional lenders that have already embraced auto-decisioning. The choice to forgo auto-decisioning models over risk concerns can leave credit unions at a competitive disadvantage. A growing number of dealers require their indirect lenders to improve approval times to keep up with increased demand from consumers for quick transactions and e-commerce options. Many banks and captives already offer advanced levels of auto-decisioning, placing them ahead of the curve compared to most credit unions.

Credit unions may be somewhat misguided in their fears of risk exposure with automatic decisioning. According to Michael Cochrum, CU Direct's vice president of advisory and analytics services, many credit unions can easily implement auto-decisioning without any changes to their current risk appetite. For example, Cochrum states that he's seen credit unions implement customized decisioning models that have increased their auto-decisions from 10% to 40% without passing their risk thresholds nor experiencing detrimental consequences later. Moreover, these credit unions have eliminated the rate sheet, therefore removing another distraction from the lending transaction. For credit unions that embraced auto-decisioning, a deal was 55% more likely to fund if it was auto-decisioned versus being manually approved or countered. In fact, the approved-to-book ratio of system-approved applications is over 90%.[7]

BEST PRACTICES

- Implement custom decision and pricing models with CU Direct's Decision Engine product. These customizable models can be programmed based on a credit union's individual risk appetite, origination objectives, and even a specific dealer's historical lending performance.

[7] CU Direct Advisory Services. March 2017.

4. FUND DEALERS QUICKLY.

Upcoming market shifts will result in increased demand for dealers to receive quick funding from lenders. While many auto lenders currently offer same day funding, some credit unions require 48 hours or more to fund dealer contracts. To expedite the funding process, credit unions can embrace technology and automated processes, while also training dealers to initiate proper contract submissions. A successful credit union indirect lending program must expedite dealer funding times as dealers will otherwise abandon lenders that tie up their critical operating cash flow.

BEST PRACTICES

- Credit unions should fund approved contracts the same day. To accomplish this, they'll need to use CU Direct's SmartFund product, which provides electronic submission of contracts via SmartFund's ImageDoc. Moreover, staff must be in place to approve the contracts and the related funding.

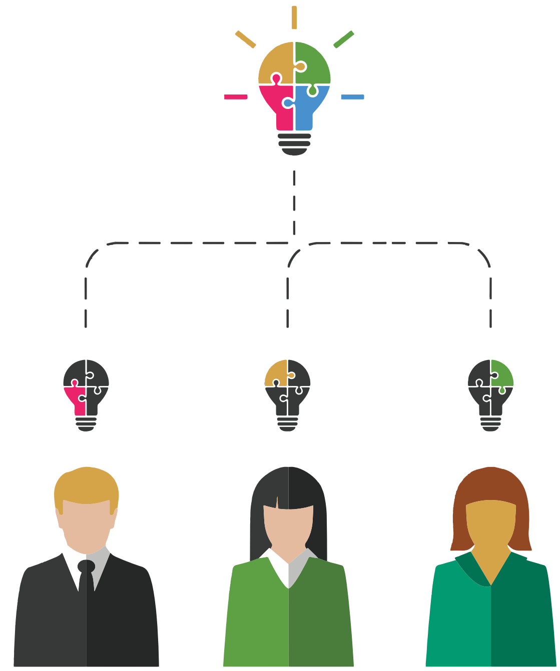
5. PUSH THE VALUE OF AUTOSMART.

The myriad of complex and costly automotive shopping and research websites will continue to place pressure on dealers to seek efficient marketing channels. Towards this end, the latest generation of CU Direct's AutoSMART product, when deployed successfully, allows participating credit unions to fill dealers' marketing and lead-gen gaps while also generating new originations for the credit union.

CU Direct's AutoSMART is an online auto-buying platform with the look and feel of the participating credit union's brand identity. It imports vehicle listings and prices from the credit union's dealer partners and organizes the vehicle inventory into a searchable interface. Credit union members can then research vehicles and prices via the branded AutoSMART site, and even call a trained auto-buying advisor for help.

The latest generation of the platform, AutoSMART 4.0, incorporates several new features over the earlier versions that serve as a building block for fast-follow enhancements. One of these upcoming features is upfront and "fair market pricing." Thus, a credit union member can use his or her credit union's "auto buying program" to obtain a fair price on a car while also receiving a low interest rate on an auto loan from the credit union.

CU Direct created AutoSMART on the industry-proven concept of using "affinity programs" to match members with car dealers. For example, TrueCar.com, one of the leading online auto buying research and price discovery sites, has managed member-buying programs for partners like AAA, American Express, USAA, and others. These programs have been successful, with affinity partners generating 32% of TrueCar's vehicle sales.[8] Moreover, for many years, the retailer Costco has maintained an auto-buying program whose main competitive advantage is simply bearing the Costco brand – yet it's proven successful for this well-known retailer and participating dealers.[9]



AutoSMART is comparable to TrueCar's and Costco's auto buying programs in key areas. For one, the credit union's trusted brand makes a member more comfortable with purchasing from a participating dealer. Second, the credit unions can engage loyal members by promoting fair pricing. Third, AutoSMART has critical mass as it relates to dealer count, with over 10,000 franchise dealerships and 3,000 independent dealers participating. However, there is a notable difference – the dealer's cost to participate in AutoSMART is significantly less than either TrueCar's or Costco's programs.

JP Morgan Chase[10] and Bank of America[11] have launched their own auto-buying platforms that offer similar functionality as AutoSMART. In Chase's case, the program, named Chase Auto Direct, is powered by TrueCar, while the lending components and branding are unique to Chase Auto Finance. From press reports, Chase reports offering dealer compensation flats that are currently lower than the credit union's average dealer flat of $450. Bank of America's program is still in its pilot stage and therefore national pricing (and dealer compensation) is still unknown. However, from a cursory examination, CU Direct's AutoSMART program is competitive with these emerging direct lending websites.

AutoSMART has the ability to be a major force in online-initiated car sales. CU Direct's credit union network has tremendous scale: nearly 45 million existing members serve as a captive audience for the AutoSMART platform. These loyal members are already "in the pockets" of just over 1,000 credit unions. Currently, 75% of CU Direct's member credit unions are signed up for AutoSMART, a percentage that will only grow by year-end. Marketed and managed properly, a credit union's "auto buying program" will prove a major value for participating dealers.

[8] https://www.fool.com/investing/2017/01/11/3-reasons-2017-could-be-great-for-truecar-inve.aspx
[9] http://fortune.com/2016/10/06/costco-cars-membership-program/
[10] http://www.autonews.com/article/20160829/FINANCE_AND_INSURANCE/160829877/chase-launches-direct-lending-with-dealers
[11] http://www.autofinancenews.net/bank-of-america-pilots-new-direct-lending-portal/

BEST PRACTICES

- Promote AutoSMART to your members by integrating the program with your website, mobile app, and advertising in your branches. Utilize marketing assets provided by CU Direct.
- Offer member-only benefits for members that purchase via the platform. These can include gas gift cards, special rates, deferred payments, free oil changes, or other offers. Consider asking participating dealers to help defray the cost of these benefits.
- Ensure that your members know that they will receive the best available loan rate from the credit union and a fair and upfront price from the dealer when using the program.
- Follow-up with members via e-mail to learn about their purchasing experience. Ask them to complete a survey, and in return, offer them a service and parts voucher (or coupon) that the member can use at a participating dealership.
- Manage participating dealers. Ensure dealers upload accurate pricing and inventory while responding to leads quickly. Request that dealers provide your members with a differentiated experience and recognize your members' affiliation with your credit union.

IDEA! A Colorado-based credit union advertises a member-specific rate on their branded AutoSMART site. Members receive an additional 25 basis point discount on their loans' rates if they purchase from a partnering dealer and finance with the credit union.

6. DEVELOP A LOYALTY MARKETING PROCESS.

For the past decade, auto dealers have used equity-mining tools to locate existing customers with positive equity in their vehicle loans. This helps dealers solicit customers better positioned to trade up to a replacement vehicle. Captives have also jumped on the equity mining bandwagon and are implementing equity mining and pull-ahead offers to encourage same-brand loyalty. Large banks, even outside of the captives, are also using equity mining tools and other attributes to determine if existing auto loan borrowers and customers from other asset classes are eligible for a new vehicle.

Today, credit unions have the ability to compete in this field by using tools like CU Direct's Lending Insights. By mining for equity with matching credit attributes, credit unions can target members with loan pre-approval offers. They can then redirect these members to their partnering dealers via AutoSMART or market other offers. In turn, this will generate credit union-attributed sales for participating dealers and also provide more loan volume for the credit union – all while encouraging member loyalty.

BEST PRACTICES

- Use data from CU Direct's Lending Insights and related credit attributes to identify members from multiple asset classes that are eligible for auto loans. Send these members to CU Direct's Decision Engine product for pre-approvals, and then to AutoSMART to find a credit union's partnering dealer.

7. INVITE DEALERS TO JOIN MARKETING EFFORTS.

In addition to affinity and loyalty marketing opportunities, credit unions can provide dealers with enhanced value by deploying other types of joint marketing efforts. Like most credit unions, dealers are a part of their local communities, and therefore engage in community-centric marketing. Sponsoring the local NBA stadium or the local Veteran's Hall are deeds that greatly encourage member loyalty.[12] The resulting synergy for the dealer and credit union to collaborate locally should lower overall marketing costs and increase the promotion's effectiveness. Keep in mind there are no limits on creativity for joint-marketing efforts.

BEST PRACTICES

- Credit union members expect special member-only treatment if asked to choose a credit union's participating dealers. Whatever these benefits are, it's important to make sure your members are aware of them.

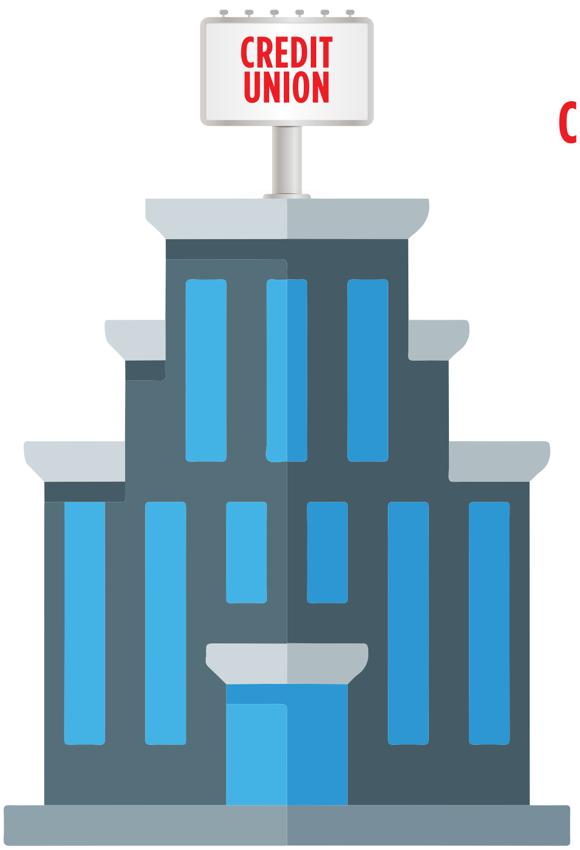
IDEA!

- A Utah-based credit union joined a local dealer chain to promote a Memorial Day Weekend auto-buying event. Credit union and dealer employees staff the event, and both the dealer and credit union heavily market the event to their customers and members, respectively. It draws a large following and the sponsors have credited the event with selling over 600 vehicles over a single holiday weekend.
- During baseball season, a Texas-based credit union that sponsors a Minor League baseball team gives away one free car each month to a lucky contestant at an event named "Get Your Free Car Night." The credit union purchases the car from a participating dealer, and promotes the dealer at the event. In return, the dealer subsidizes the price that the credit union pays for the car.

[12] http://www.creditunions.com/blogs/industry-insights/branch-enhancements-and-community-involvement-contribute-to-double-digit-growth/

WRAPPING UP

Credit unions must embrace change to provide continued value to dealers that are facing their own market pressures. If not, dealers will quickly switch to other financial institutions that can better meet the needs of their operational models. In any car sales market, credit unions will always face competitive pressure from other lenders seeking to fill their auto loan asset coffers with loans. While indirect lending is currently profitable and competitive for many credit unions, they must make strategic investments in technology, revamped processes, and other resources to ensure that these programs remain competitive, profitable, and sustainable in the future.



TO LEARN MORE ABOUT HOW WE CAN HELP YOUR CREDIT UNION THINK ABOUT THE AUTOMOTIVE RETAIL INDUSTRY, FEEL FREE TO CONTACT US DIRECTLY:

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We are a U.S.-based consultancy that provides automotive-related advisory services to companies, investors, and professional firms. Our projects run the gamut from simple phone conversations to large-scale consulting engagements. Our leadership team has experience in the finance and tech industries, which assists us in providing multidiscipline perspectives on the auto industry.

Maryann Keller, our firm's principal, is one of the auto industry's most respected and well-known automotive analysts. Ms. Keller, with our firm's leadership, brings in-depth multi-industry experience to our clients.

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