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The Growth of Credit Union Auto Lending

How lower regulatory hurdles, smarter technology, and stronger dealer relationships are driving indirect growth...

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Summary:

As many regional banks consolidated or went out of business during the recession, credit unions stepped in to take advantage of the void left by these lenders, particularly in auto lending. In the last five years alone, credit unions have maximized their indirect lending efforts significantly, making them a growing force in auto lending that is taking away market share from banks. While credit unions' $1 trillion in total assets seem paltry compared to the $16 trillion amassed by banks in the U.S., these smaller, community-based financial institutions have begun to outpace their banking rivals when it comes to auto lending.

Introduction:

A special thanks to Maryann Keller. Without her insights, this analysis would not have been possible.

One in three Americans are members of a credit union, equating to 50% of all employed Americans. In auto lending, credit unions are the second largest originator, having nearly doubled their originations in the past five years.[1] In certain states, they surpass 50% of total new car loans. This growth continues throughout the country, where one in four vehicles bought in the U.S. is financed by credit unions, marking a 20% year-over-year increase that is largely the result of indirect growth.[2]

Credit unions are on track to make even more market share gains as they become a stronger force in U.S. auto lending. With the ability to exploit unique competitive advantages of their models, credit unions can offer consumers lower rates and more attractive lending terms compared to most banks. According to a study by American University, "Credit union rates on new and used car loans are 28 percent lower than bank rates, on average."[3] Credit unions benefit from significantly lower operating costs compared to large institutional lenders and consequently pass these savings on through lower interest rates. Other competitive advantages driving the growth of credit union auto lending include:

1. Streamlined Technology & Economies of Scale
2. Indirect Dealer Efforts
3. Lenient Regulatory Environment
4. No Taxes, Access to Deposits

Let's take a look at each of these factors more closely.

CUSOs: Streamlined Technology & Economies of Scale

2010 marked a major shift in thinking for credit unions as they began to actively pursue auto loans through indirect channels.

Technological advances in the mid-1990s led to a new lending platform that allowed any size credit union the ability to compete with large indirect lenders (e.g. banks like JP Morgan Chase and U.S. Bank) by electronically connecting dealers and credit unions. This CU aggregator (or CUSO), called CU Direct, boasts over 1,100 participating credit unions as members and 11,400 dealers nationwide.

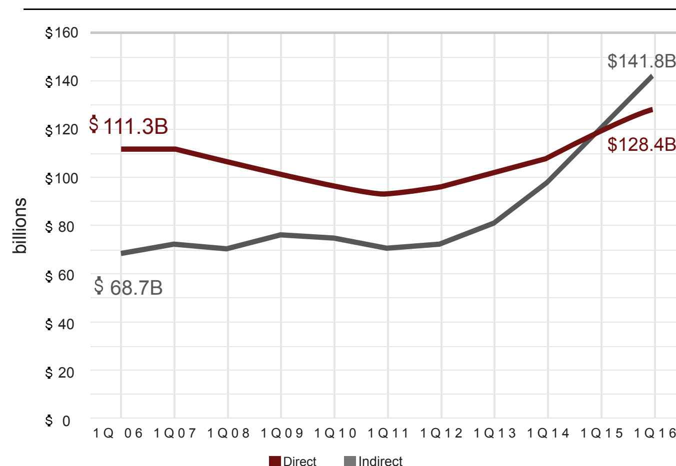
CU Direct's lending platform also provides credit unions with saleable F&I products like vehicle service contracts. Automotive News reports that in the five years since fully taking advantage of this platform, indirect auto lending through CU Direct's network almost doubled, rising from $70.2 billion to $137.3 billion.[4]

CU Direct's technology is advanced, providing a credit union with virtually the same frontend and backend technology as billion dollar banks competing for the same borrower. For auto lending, CU Direct provides not only the fundamental electronic integration between dealers and credit unions, but also the ability to automatically approve originations. CU Direct's product, dubbed the 360 Loan Origination System, allows a credit union to automatically approve auto loans that meet certain and definable criteria. This functionality is a key strategy for credit unions, as the length of decision time has been a loss point for them in the past. According to one study by CU Direct, the probability of funding an approved application rose by as much as 55% when the application was approved by the automated system rather than manual approval by a credit union analyst.[5]

In addition to technology, CU Direct allows a credit union to take advantage of economies of scale with a nationwide infrastructure of lender related services ranging from asset recovery to remarketing services.[6] Access to compliant and discounted vendors on a nationwide basis provides even the smallest credit union the opportunity to compete with much larger banks on controlling operating expenses.

Without undercutting rates, lowering underwriting standards, or increasing dealer incentives, many credit unions have been able to compete with indirect banks by simply taking advantage of CUSO related benefits. While CU Direct is the biggest, it's not the only CUSO supporting credit unions' growth efforts. Industry experts predict that as more credit unions embrace technology offered by CUSOs, whether it's auto approval technology or simple indirect lending capabilities, even more auto loan originations will end up with credit unions.

Indirect Dealer Efforts: Targeted Outreach Provides Partnership Growth



"Indirect[credit union] lending overtook direct lending in the first quarter of 2015 and has remained on top for the past five quarters. Year-over-year, indirect lending boasted a 18.8% growth rate while direct lending expanded 7.6%" - Liz Furman, Callahan & Associates.

Following the economic crash, many traditional lenders left the auto market in 2009, giving credit unions more space to take up market share. Credit unions not only continued to fund loans, but also joined dealers in promoting programs like Cash for Clunkers.[7] "We can say that the true engagement of indirect lending has happened from 2010 to 2015," explains Jose Torres, senior business analyst for CU Direct.[8]

Some of this expanded business has been a direct result of credit unions filling specific needs for auto dealers. While credit unions have learned how to leverage technology to address approval turnaround needs, they have also been caressing dealers in other areas in order to attract their loyalty in the indirect channel.

One marketing tactic has been to use member loyalty as a way to refer credit union members directly to dealerships. There are several ways this is executed; for example, dealers may agree to provide members with special pricing, or credit unions might promote specific dealers that receive high rankings from members' past transactions. Some credit unions also create specialized offers allowing their preferred dealers a specific competitive advantage over other dealers, such as deferred payments for 90 days.[9]

CREDIT UNIONS FINANCE USED CAR SALES HEAVILY, TOO.

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Credit unions have become a major player in used car financing as well. According to Experian data, credit unions are the second largest lender type in used car financing, commanding 23.9% of the market.* In 2015, for example, Enterprise generated $483 million in credit union loans alone. Because Enterprise's main focus is de-fleeting rental cars cost effectively, they are not as concerned about F&I profits. Consequently, the company has built a strong partnership with credit unions, even advertising on their behalf. Many credit unions return the favor by maintaining a direct link to Enterprise on their home pages.

*http://www.experian.com/assets/automotive/quarterly-webinars/2016-q1-safm.pdf

The increasing prevalence of flats is also helping to improve credit unions' relationships with dealers. A recent major issue for dealers is the CFPB's assault on the dealer markup system, which increasingly limits the F&I manager's ability to markup rates and profit from reserves. Melissa Cole, a finance director with the Sullivan Automotive Group, recently told Automotive News, “Less and less of my business is reserve.”[10] As more dealers face lower reserve income, the dealer’s acceptance of being paid “flats” by lenders has become better tolerated. In the past, this was often a road block to credit unions obtaining auto loan business because they were the only ones prohibiting dealers from marking up rates. Now, however, more and more banks are reverting to the flats system, putting credit unions on par with their competitors in this category. Moreover, to help compensate for this loss of revenue for dealers, credit unions have begun to adjust their flats to better attract dealers. Some credit unions have increased flats across the board, while others offer higher flats to dealers with a high customer satisfaction score.[11]

Before the flat system became more common, certain F&I managers would attempt to “beat the system” by switching a credit union customer to a loan from another financial institution that offered a higher reserve. However, as a result of new technologies and data tracking, the credit unions can now identify when and where this is occurring, and can subsequently remove those dealers from their network. This leaves little incentive for F&I managers to perform any bait and switch moves.

In addition to greater transparency between dealers and credit unions, today’s auto borrower has also become more educated and empowered. They often shop for and commit to an auto loan before making a vehicle purchase – a trend that is only set to grow. Just recently, on June 9, the CFPB announced an initiative to educate auto consumers before they select an auto loan.[12] The effort, dubbed “Know Before You Owe,” provides a shopping worksheet to provide consumers with auto loan transparency before taking out a loan. The CFPB explains that currently only 50% of consumers actually shop for an auto loan before heading to the dealership; however, that number is expected to grow as consumers become more informed about their ability to significantly save on auto loans. As a result, an increasing number of consumers will contact their credit unions for an auto loan before visiting a dealership, therefore increasing the likelihood that the credit union will refer the consumer to a partnering dealer.

Credit union membership has also benefitted from the increase in auto lending. According to a Credit Union National Association (CUNA) annual report, much of the growth of the credit union membership base is being driven by “indirect auto lending and [the] greater recognition of the credit union value proposition."[13] In the case of CU Direct, a whopping 61.7% of auto loans are new credit union members joining at the dealership.[14] Just as credit unions utilize personal relationships to garner business from their local communities, they have now taken this model to successfully establish mutually profitable relationships with auto dealers.

The Regulatory Environment: Fewer Restrictions Keep Credit Union Rates Low

Perhaps the largest competitive advantage credit unions have over banks is their ability to offer cheaper rates, which is largely due to several regulatory related factors. While banks and other larger financial institutions face increasing regulatory burdens, credit unions are exempt from many of these restrictions. This may seem contradictory because some credit unions have national scale with a million members, despite being seen as small local or regional entities controlled by members. Five credit unions total over $10 billion in assets, and the largest, Navy Federal Credit Union, has over $58 billion in assets.

Still, even with the size of a handful of larger credit unions, there are valid reasons for lighter regulations on this industry. First, credit unions are member-owned cooperative financial institutions overseen by a board of non-paid volunteers. That means every credit union member is an owner of the institution. Thus, unlike banks that must make decisions to benefit their shareholder returns, credit unions only need to focus on their members' interests and have little incentive to do otherwise. Towards this end, since credit unions are not for profit, they reinvest their earnings into lower lending rates and higher deposit rates for their members – whereas banks must maximize earnings to appease shareholders. Another key difference in business models is that credit unions are largely focused on consumer lending rather than riskier commercial lending that is commonly pursued by banks. While credit unions can provide business loans, the majority of their lending is low loss consumer lending to their members.

Finally, and perhaps most importantly, credit unions are careful lenders, particularly when compared to many banks. They have lower delinquency and charge-off rates, in multiple asset classes across the board. And because common bond memberships often center around employers, credit union members typically have steady employment. The credit union, by its nature, has real information about the member's financial status since they often obtain credit card and mortgage statements that demonstrate a history of payments rather than solely examining a credit report, as banks typically do. These extra measures strengthen the quality of credit unions' auto loans significantly and bolster the argument for fewer regulatory burdens from the government.

A "LIFEBOAT" DURING THE CRISIS...

Credit unions did not cause the financial crisis. On the contrary, many car dealerships credit them with actually serving as auto lending "lifeboats" during the crisis. Many car dealers would have faced extinction if it wasn't for the continued lending by credit unions during a tumultuous period when other lending markets suddenly dried up.

So how are credit unions overseen? The federal regulator is the National Credit Union Administration (NCUA) – an administration that has been consistently hammered by Congress to be even more lenient towards credit unions. While state regulators also oversee credit union activities, credit unions, unlike banks, are exempt from OCC oversight, Federal Reserve rulemaking, FDIC requirements, and are mostly exempt from CFPB examinations. Credit unions with over $10B in assets are subject to CFPB oversight & enforcement; however, all credit unions are subject to CFPB rulemaking.

Thus, many of the significant federal regulatory rules that have been placed on banks post-financial crisis have evaded the credit unions. Credit unions continue to receive tremendous support from lawmakers and regulators for even lower regulatory standards. Congress recently petitioned for credit unions to be exempt from all CFPB rules, and even CFPB Director Richard Cordray referred to credit unions (and community banks) as "the most responsible lenders."[15] These fewer regulatory requirements have directly contributed to lowering credit unions' regulatory operating expenses as compared to their banking counterparts.

It's not surprising then that the regulatory future continues to look bright for credit unions. Just recently, the NCUA announced new rules to take effect this fall that will allow credit unions to expand their already broad definition of a "member," thus allowing credit unions to expand their customer base with even fewer constraints.[16] With even less stringent requirements defining the "common bond" amongst credit union members, credit unions will be able to take advantage of even lower regulatory operating costs, allowing them to continue offering more competitive rates in auto lending.

Other Advantages: No Taxes Plus Access to Deposits (Money)...

Unlike banks, credit unions are not for profit institutions that are exempt from federal income taxes. This exemption, which is continuously challenged by commercial bank lobbyists, is a major advantage for credit unions. According to the American Bankers Association, credit unions have been exempt from paying a cumulative $20.5 billion in income taxes since 2001.[17] Credit unions argue that the money saved has been directly reinvested into lower rates on loans for consumers. Regardless of whether the bulk of these tax savings are truly being reallocated to drive down rates for consumers, it remains certain that this tax benefit largely affects the ability of credit unions to offer competitive rates, particularly when it comes to auto lending.

In addition to tax benefits, credit unions also have access to a large deposit base, just as larger competing banks do. Credit unions obtain deposits from various products, including checking deposits, saving accounts, IRAs, money markets, CDs, and other sources. While these deposit sources generate significant funds that credit unions can lend, they also create an interest payment liability for the products that promise a return to the account holders. Thus, access to deposits met with an obligation to pay interest to depositors, encourages credit unions to offer attractive rates and longer terms on auto loans and other lending products in order to pay the credit union's interest obligations.

Where credit unions differ from their banking counterparts in competitive lending is in their ability - and willingness - to collaborate with each other. In order to assist other credit unions with concentration limits, credit unions actually work with each other on sharing competitive loans – something rarely seen in banking. As John Vincent, automotive consumer advice writer and board chair of Oregonians Credit Union puts it:

"Credit unions with high loan-to-share ratios or those approaching concentration limits are often willing to negotiate participations with credit unions with low loan-to-share ratios, or [those that have] room under their concentration limit caps. In this way, the rising tide lifts all credit union boats. Such cooperation amongst banks is rare."[18]

Could Credit Unions Gain Traction Over Online Marketplace Lenders Engaging in Auto Lending?

In what could be a major upset to marketplace lenders, credit unions will soon be able to serve members solely via the Internet,[19] providing them with a unique opportunity to gain online market share. In addition to this development, many credit unions have joined forces to forge strategic partnerships with fintech companies and develop new technologies. For example, Washington State Employees Credit Union, a $2.4 billion CU based in Olympia, along with several other credit unions, have partnered with a company named Best Innovation Group (BIG), creating a collaborative that is introducing new technology specific to the CU space. “Our company model is to go out and find what we think are interesting companies and vet different companies we think would be a good fit for the credit union space," said BIG’s CEO John Best.[20] Ben Morales, Chief Technology Officer of WSECU, further explains, "I think the partnering is starting with CUs making some monetary investments and will likely evolve into new product development." By expanding the capabilities and user-friendliness of credit union websites, they are better able to compete with larger banks and online lenders. These changes mark the beginning in a shift to greater online presence for credit unions, which could potentially lead to new products further down the road. In addition to increasing technology capabilities, credit unions also have other advantages that outpace marketplace lenders.

In the past, marketplace lenders have benefited from significantly less regulatory oversight compared to banks. However, regulators have recently promised further regulatory scrutiny of these lenders as consumer complaints continue to grow. Meanwhile, credit unions are ready to step into the online market armed with an extensive deposit base, trusted brands, lending and loss experience, lobbying power, and growing dealer relationships. With access to the same “online” technology that was once exclusive to fintech startups, borrowers can choose the credit union that already has their checking account, mortgage, and existing auto loan – and avoid the uncertainty of dealing with an unknown lending startup. Although marketplace lenders have benefited from sky high Silicon Valley valuations, they’ll face major challenges in their attempts to compete with credit unions.

But credit unions are not exempt from challenges either, especially as they grow in new spaces. They will need to contend with their internal ability to properly understand and assess the risk associated with moving beyond their defined membership base. As they begin to act more like ordinary lenders, credit unions may also witness higher default rates compared to historic measures. The largest credit unions will likely be able to handle this shift, but those in the middle run the risk of stretching their capabilities if they grow too fast.

CREDIT UNIONS ARE VIEWED AS TIED TO THE COMMUNITIES THEY SERVE...

Credit unions are regarded as good corporate citizens. They support their communities by sponsoring local events, providing scholarships, joining chambers of commerce, donating their employees’ time, and contributing in various other ways. A credit union’s commitment to their community helps to maintain the loyalty of their members.

Credit Unions are Poised to Gain More Auto Lending Market Share

INDIRECT LENDING BREAKDOWN BY NUMBER OF CREDIT UNIONS

For all credit unions I Data as of 03.31.16
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INDIRECT LENDING BREAKDOWN BY TOTAL AUTO LOANS

For all credit unions I Data as of 03.31.16
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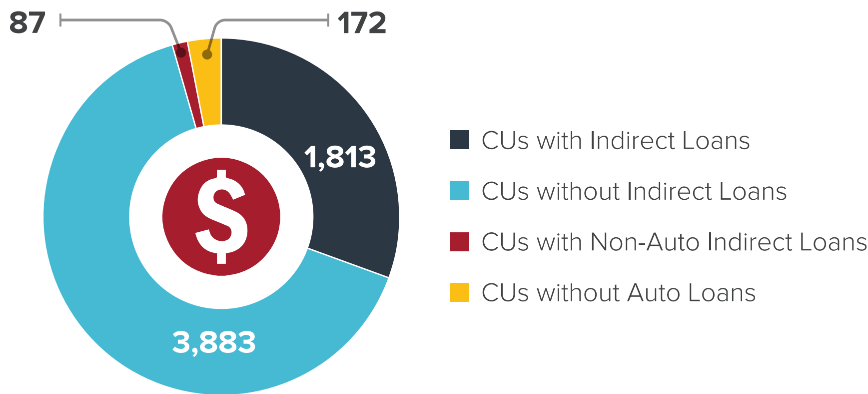

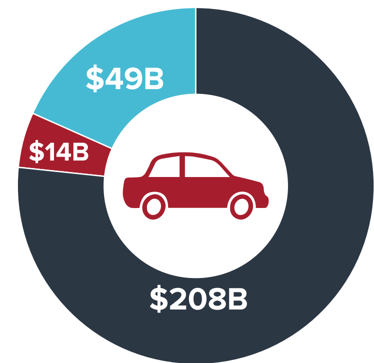

"The Rise of Indirect Lending" Source: Callahan & Associates ©.
http://www.creditunions.com/mobile/blogs/industry-insights/the-rise-of-indirect-lending/

By offering more competitive rates and loan terms to their members while developing mutually beneficial relationships directly with dealers, credit unions have become a driving force in the auto lending industry. Competitive advantages include technological sophistication, lighter regulation, and no income tax, all of which have made it difficult for banks to compete. With only 30% of credit unions engaging in indirect auto lending, yet holding 77% of the credit union industry's auto loans, the opportunity for growth is tremendous if more credit unions embrace indirect auto lending.[21] Unless banks begin to shift their focus on expanding dealer relationships, increasing incentives (for both consumers and dealers), and keeping up with innovative technology, it's fair to predict that credit unions will continue to take away market share from larger financial institutions.

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