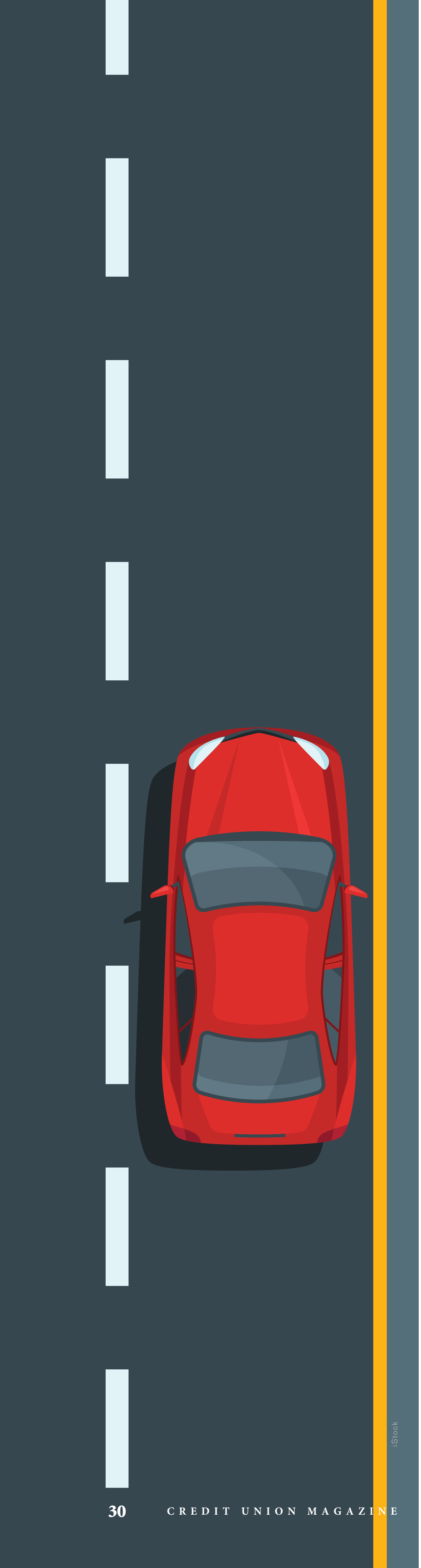

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# MIND YOUR MARGINS

Ted Goldwyn

## Five steps to get the best return from your auto loan portfolio.

### Focus

- **Auto lending** remains strong, but the road to success is about to become a little bumpier.
- **Find** markets where others fear to tread, such as nonprime lending.
- **Board focus:** Members ultimately benefit from a healthy auto loan portfolio and credit unions' lower interest rates.

Credit union auto lending has been on a tear of late, with double-digit growth each year from 2013 to 2016 and consistently high credit quality, according to CUNA research and policy analysis.

But there are signs this remarkable growth trend might slow due to a softening economy, slower growth in new-auto sales, rising reserve requirements, and growing competition, particularly from captive finance companies.

"Many economists predict we're one to two years out from the next recession," says Joseph Breeden, chief operating officer/chief scientist at Deep Future Analytics LLC. "Even though unemployment is low, losses in auto lending, even normalized for credit risk, have been rising for the past year."

Despite these trends, most credit unions continue to enjoy high yields and strong growth in this segment. Key to their continued success will be optimizing their auto loan portfolios via data-driven portfolio management and a willingness to venture into waters where competitors are less likely to swim.

### Captive competition

Credit unions face several tough currents in auto lending. On the competitive front, aggressive dealer pricing and manufacturer incentives have long made it difficult for noncaptive lenders such as credit unions to compete.

This trend has intensified as dealer incentives such as cash back and low-rate financing have reached a record-high average of $4,000 per vehicle, according to the automotive research firm WardsAuto. Analysts predict incentives will continue to grow as the new-vehicle market softens.

"One of the biggest challenges is increased incentive spending from auto manufacturers," says David Brydun, vice president of consumer lending at $2.6 billion asset Baxter Credit Union (BCU) in Vernon Hills, Ill. "It's quite difficult to compete with 0% financing."

Industry experts also are keeping a sharp eye on the coming implementation of the Financial Accounting Standard Board's new Current Expected Credit Losses (CECL) standard, which will affect all financial institutions.

CECL is likely to affect auto loans and mortgages disproportionately due to the standard's requirement that lenders must begin using forward-looking predictive loss models.

As a result, credit unions may need to adjust their lending strategies to accommodate the accounting changes.

"Under CECL, credit unions will need to change how they calculate loss reserves," Breeden says. "We expect loss reserves for auto loans will increase by a factor of two, whereas for some other products like credit cards, reserves will likely decline. This means that until pricing adjusts, credit unions will look to rebalance their portfolios because of the new CECL accounting regulations."

### Five steps to success

Despite these challenges, credit unions can adopt strategies to optimize their auto loan portfolio returns for members' ultimate benefit. Five best practices:

1 **Find open water.** Seek out new market segments where competition is less intense. Paul Ablack, CEO of OnApproach, cites the book "Blue Ocean Strategy" as a roadmap for this strategy.

"It's a simple concept that says the red ocean is where all the sharks are fighting and the blue ocean is where the sharks are not," Ablack says. "Right now, the waters are bloody in indirect lending. So if you can go into new markets with risk-based pricing, it allows you to steer away from these very bloody waters and head into uncharted territories."

Ablack cites opportunities within nonprime lending, which many lenders avoid because the perceived risk is too high. "If you're lending to someone with a 700 credit score, the credit union will earn 50 or 60 basis points" on the loan, he says. "Margins are very thin, and credit unions need to think about heading more into used vehicles or into lower credit tiers on

# 'Consumers rarely shop for loans.'

**Michael Cochrum**

new vehicles, or even recreational vehicles."

Doing so will benefit members, too. Finance companies charge well into the double digits for subprime loans, whereas credit unions have the lowest auto-loan rates in nearly every credit tier ("Average new-auto loan rates").

Credit unions, for example, charge an average of 2.62% for five-year new-auto loans, according to the CUNA Benefits of Membership Report. That's 1.19 percentage points less than banks' 3.81% average rate.

"That means a consumer financing a $30,000 new car over five years would save roughly $190 per year—or $950 over the life of the loan—by financing at a credit union," says Jeanne Sheahan, CUNA's director of research services.

**2 Embrace origination technology.** To take full advantage of auto lending opportunities, credit unions must tackle every aspect of the process, starting with origination.

"Consumers rarely shop for loans," says Michael Cochrum, vice president of analytics and advisory services at CU Direct Corporation. "They actually shop for goods and services and obtain loans to purchase those. We found that if credit unions can engage the member earlier in the buying cycle there's a greater chance of getting the loan. The first step is optimizing origination opportunities."

To do so, credit unions must make the loan application and funding process seamless and convenient for both members and auto dealers. "The member experience is one of the most important parts of the process," Cochrum says. "We're in a consumer environment where people expect quick response times to inquiries."

Plus, "credit unions need to be faster in responding to dealer partners when customers are ready to buy," he continues. Making the origination process more seamless and convenient now requires credit unions to originate and fund auto loans entirely online.

**3 Use dynamic pricing.** While lenders have been using risk-based pricing models for decades, today's models are increasingly data-driven and responsive to changes in the marketplace.

"We use risk-based pricing, as many other credit unions do," says Matt Kershaw, CEO at $647 million asset Clark County Credit Union in Las Vegas. "But we believe we can dig deeper into the credit range."

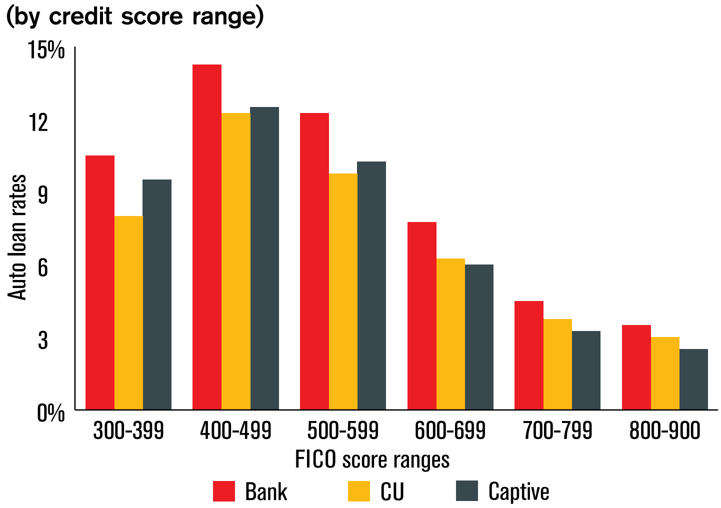
Clark County will grant loans to members with credit scores in the low 600s or even 500 range because it manages risk by analyzing additional factors such as loan to value (LTV), loan term, and vehicle age. This allows the credit union to take a member-friendly, "approve-first" approach.

"Although a good portion of our portfolio is in A and B credit, we also have a good portion in C, D, and even E credit," Kershaw adds. "It's important to maintain a good yield, but at the same time we strive to meet our members' needs."

Dale Fosselman, chief corporate development officer at $664 million asset Denali Federal Credit Union in Anchorage, Alaska, agrees many opportunities exist to earn healthy yields within higher-risk segments of the market, particularly because much of today's auto

### Average new-auto loan rates

**(by credit score range)**




**Source:** AutoCount

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loan pricing is overly risk-averse.

"Credit unions tend to be a little conservative" and risk-averse," Fosselman says. "Some of our more profitable portfolios are the segments with below-700 scores and greater than 100% LTV because the market is over-pricing for risk."

As of March 2017, he says, Denali Federal's auto loan portfolio enjoys market-beating yields of 6.1%.

Credit unions are "significantly underpriced"—by 100 basis points—among C credit auto loans (credit scores of 600 to 699), Cochrum says. "There's room to raise prices."

Credit union auto loan portfolios are heavily weighted in A and B auto loan paper. Roughly 22% of their auto loans are made to people with credit scores of 800 to 900, and 21% to consumers with credit scores of 700 to 800, according to CU Direct.

**4 Go direct.** Some credit unions work with members from the beginning of the auto buying process, making them the natural first choice for members' auto loan needs.

Ninety-percent of BCU's $325 million auto-loan originations in 2016 came from its direct channel, with the rest from indirect dealer relationships.

"Focus on building a strong direct-to-member model," Brydun advises. "The profitability of your auto loan portfolio will improve due to lower loan acquisition costs. And if you have the ability to sell ancillary products like warranty and GAP [guaranteed asset protection] insurance, you'll increase [revenues] even more."

Success with direct lending requires ongoing communication of the credit union's value proposition through digital channels, direct mail, and call center marketing campaigns, Brydun says.

BCU also partners with TrueCar to offer a comprehensive auto buying service to members. Beyond offering tangible member value, the service involves the credit union from the beginning of the auto buying process.

**5 All things analytics.** With CECL looming on the horizon, a data-driven, analytical approach to auto loan portfolio management is more critical than ever.

"This is a really tough thing to do intuitively," Breeden says. "You need some actual numbers where you can say, 'Here are the opportunities and here are the risk zones,' and start making adjustments."

continued ▶

## BEYOND THE AUTO LOAN

Many credit unions struggle with converting single-service members into true relationships, particularly when that service is an auto loan that pays off within an average of 2.5 years.

Credit unions and credit union service organizations are trying new, innovative approaches to grow member relationships, whether the loan was made directly at a branch or indirectly at a dealership.

Paul Ablack, CEO of OnApproach, encourages credit unions to create an "auto ownership experience" with indirect members, an experience that goes beyond the loan. This ranges from cross-selling traditional wrap-around products such as GAP (guaranteed asset protection) insurance, extended warranty, and debt protection, to offering coupons for maintenance through a local service shop.

"If I can take an auto loan and then sell additional services around it that benefit both the member and the credit union, it now changes the equation," he says. "It allows me to offer a competitive rate but not lose money and make a bad business decision if I can wrap these products around it."

OnApproach is exploring a new smartphone app that allows credit unions to track the auto loan relationship and actively engage with members over time.

"With the app, the credit union will know the loan is three years in and it's time to start looking for another vehicle because the member is inputting their current vehicle's mileage periodically," Ablack says. "Through this app, the credit union is now engaging with members on a regular basis about their auto ownership experience and providing these additional services."

Member convenience is key in establishing a loyal relationship, lenders say.

"We are above average when it comes to converting the transaction to a relationship," says Dale Fosselman, chief corporate development officer at $664 million asset Denali Federal Credit Union in Anchorage, Alaska. "I think that's mainly a product of how convenient we are with our home banking and because we maintain a lot of in-store branches in grocery stores."

Michael Cochrum, vice president of analytics and advisory services at CU Direct Corporation, agrees. "That's the starting point. Where you see the disruption in fintech companies today is when people can create these autonomous experiences.

"If I open a car loan with your credit union and it's difficult to make a payment because you won't allow me to make it online," he continues, "it's going to be hard to convince me that I need to open my checking account with you as well."

FOR MORE WAYS TO INCREASE PRODUCT USE AMONG INDIRECT MEMBERS, VISIT **NEWS.CUNA.ORG**

Deep Future Analytics, a credit union service organization owned in part by Denali Federal, maintains a shared data repository it uses in its modeling. Credit union clients share their individual portfolio performance metrics with the repository and in turn get the benefit of a deeper, broader data set and a better model overall.

"That works well because the models we build can be more robust in understanding overall patterns, yet still calibrated to the individual institution's underwriting," Breeden says.

Denali Federal uses Deep Future Analytics' credit risk model to manage its auto loan portfolio. "We use a forward-looking loan level model based on economic scenarios to estimate the probabilities of defaults and attrition, and to do some balance modeling to give us an economics-based estimate of future risks in the portfolio," says Greg Nolder, the credit union's vice president of applied analytics. "At origination, we use attributes such as direct versus indirect, new versus used, LTV, term, and credit score.

"On an ongoing basis for every loan," he continues, "we track delinquencies and loan performance. Part of the model correlates some components of our history to economic parameters such as unemployment, housing prices, and disposable income to drive forward-looking scenarios. We also track mortgage, auto loan, credit card, and personal loan rates."

The more granular the data inputs, Nolder says, the more accurate the model—and the greater a credit union's ability to predict future portfolio performance.

## RESOURCES

▶CUNA:

1. Benefits of Membership Report: *cuna.org*, select "research & strategy"
2. *Credit Union Magazine,* 5/17, p. 36: "CECL is coming: Are you ready?"

▶CU Direct Corporation: *cudirect.com*

▶CUNA Lending Council: *cunacouncils.org*

▶Deep Future Analytics: *deepfutureanalytics.com*

▶OnApproach: *onapproach.com*