# Loan Zone: Indirect Lending

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*As car sales pick up, are you ready to face the risks?*

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It is beyond dispute that automobile sales continue to gain steam. As automobile sale records are being set, credit unions are realizing an increase in indirect automobile lending. In 2012, the National Credit Union Administration estimated that indirect lending for auto loans increased more than 10 percent; in 2013, more than 18 percent; and in 2014, in excess of 21 percent. Today, approximately 2,000 credit unions have an indirect lending program and all seem to focus on the benefits of such programs, including potential new loans, membership growth and cross-selling opportunities.

However, in today's environment it is important to take a hard look at the risks and potential drawbacks of indirect loan programs. Threats like fraud, increased loan losses, uncontrolled growth and lost income can lead to unpleasant membership experiences and do great harm to a credit union's reputation.

These risks have become a significant safety and soundness concern for NCUA, and while regular reporting to the board of directors is critical for problem prevention, it is also important for management to recognize potential risks, including;

- rapid growth, which can lead to a material shift in the balance sheet,
- credit risk,
- liquidity risk,
- transaction risk,
- compliance risk,
- reputation risk, and
- increased delinquencies.

Further guidance can be found in the NCUA Letter to Credit Unions, 10-CU-15, "**Indirect Lending and Appropriate Due Diligence.**" In the letter, NCUA cautions: "While there are benefits to a well-run indirect lending program, an improperly managed or loosely controlled program can quickly lead to unintended risk exposure."

Some of the red flags and issues of significant concern to NCUA include:

- incentive programs tying loan officer bonuses to indirect loan volume,
- a high concentration of indirect loans to total loans or net worth without adequate controls in place,
- insufficient loan documentation,
- inadequate analysis of overall indirect loan participation performance,
- high instances of first payment default, payment deferment and account re-aging, and
- poor dealer management.

Additionally, the Consumer Financial Protection Bureau has joined the parade and issued a report that details **auto lending discrimination** at banks. The report states that up to 190,000 consumers have been harmed by discriminatory practices by dealers in improper or inadequate automobile financing programs and suggests the non-bank auto finance market needs better controls as well. This report serves as an advisory warning to all credit unions.

In March 2013, CFPB issued a controversial bulletin entitled "**Indirect Auto Lending and Compliance With the Equal Credit Opportunity Act.**" The bulletin addresses auto lenders' accountability for auto dealers' illegal discriminatory markups of loans the lenders purchased. CFPB also imposed a number of enforcement penalties against certain banks engaged in indirect auto lending and released a "**Supervisory Highlights**" report detailing the auto lending discrimination.

To limit fair lending risks, CFPB identified  the following institutional guidelines:

- Conduct internal monitoring to correct for potential discrimination stemming from discretionary pricing policies.
- Eliminate dealers' ability to mark up the price of a loan. Instead, compensate fairly using a different mechanism.

CFPB, while not seeking to abolish the concept of indirect lending or "participation" fees to dealers, is striving to fundamentally reform the market by eliminating the dealer's discretion in setting interest rates.

Any article by an attorney most certainly should focus on some of the legal issues and contract requirements. All indirect lending written contracts should address at a minimum: dealer compensation, credit criteria, documentation standards, dealer reserves controlled by the credit union, and a dispute resolution and exit clauses.

Credit unions should regularly test for compliance with contract terms by comparing delinquency, loan losses and rates of return to previous results in budget levels. There should be periodic dealer audits, including such items as direct contact by the credit union with the “new member” to confirm compliance with all aspects of the transaction, including field of membership.

As an example, a credit union client recently came across a troubling situation. After auditing a dealer, this CU sought to confirm what field of membership criteria the dealer was presenting to potential car buyers. The CU found that an employee at the dealer had misrepresented field of membership requirements to nearly 20 “new members.” This would never have been identified without the credit union’s audit.

It is important for credit unions to enforce strong internal controls to prevent and detect fraud. Strong internal controls would include but not be limited to:

- sufficient staffing levels to allow for segregation of duties,
- restricting inappropriate access to date,
- ongoing training of both the dealer and credit union staff, and
- procedures to ensure limited exceptions to established policies and quality control.

Indirect lending is a powerful lending tool for use by credit unions, but be prepared for the risks.

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