An Oracle White Paper
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Auto Finance Gains Consumer Credit's Lead Position

The Consumer Finance Market: Where We Are

The U.S. consumer credit portfolio is hemorrhaging loan balances at a never-before-seen rate. Since 2008, when loan balances totaled US$13.7 trillion, more than US$1 trillion has vanished from the portfolios of regulated financial institutions that earn much of their revenue from interest and fees on loans. Every product portfolio shown in Figure 1 lost billions of dollars in balances in less than five years. Some products, such as mortgages and home equity lines of credit (HELOCS), will take many more years to recover (if ever they do), student loans will never recover, and credit card and small business loans will also languish. Auto finance is the only market to date to show signs of recovering as new auto sales continue to grow and balances increase with them. Most noticeably to blame is the U.S. economy—however, there is more to it than that.

U.S. Consumer Loan Balances by Loan Type, May 2013. (N=US$12.7 Trillion)

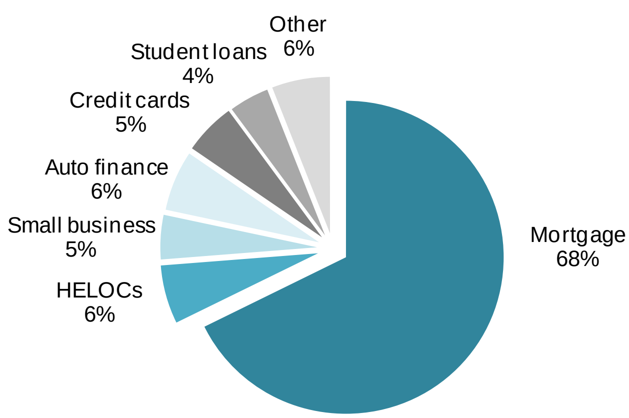

Figure 1: Decline in Consumer Loan Balances Exceeds US$1 Trillion in Less Than 5 Years
Sources: Aite Group analysis of data from Federal Reserve, SBA, Department of Education, and other industry sources

Leading Factors: Economics, Regulations, and Risk

The U.S. economy has been in the midst of an economic hard landing for some years now. Unemployment remains unacceptably high, permanent job loss continues to be estimated at 15 million, while geopolitical gridlock, threats of a euro zone implosion, and the effects of a burgeoning U.S. national debt are key contributors to consumers' distress. Other factors include:

- Natural disasters such as tornadoes, hurricanes, and wildfires, whose impact and geography cannot be predicted
- Rising energy costs

- Falling housing prices and financial markets
- Fragile new auto sales
- Obama care (the latest threat to businesses and retirees)

Consumers do not feel good about their financial health. They fear losing their jobs, homes, savings, and retirement. When consumers are afraid, they stop spending and borrowing. In turn, the “good” consumers pay down their balances. These factors, in addition to government-induced low interest rates, have caused a significant loss of revenue and deterioration of credit businesses' performance.

And while the good consumers are paying down their balances, others are not paying their bills at all, thus thrusting much of the credit portfolio into serious delinquency. Loan balances have been written off at very high levels over the past few years. At the same time, the numbers of loan accounts that financial institutions must manage do not disappear nearly as fast as the portfolio balances. That they must manage these loan accounts without financial support from new account revenue seriously impacts banks' and credit unions' financial returns.

Lately, IT has provided little help in driving processing costs down. In normal times, institutions would manage debt collection with help from IT and operating resources. Unfortunately for most banks, credit unions, and finance companies, these resources are busy with regulatory compliance and thus unavailable.

Regulations and Regulators

Since 2010, the Dodd-Frank Act has been wreaking havoc on regulated institutions, whether through mandating massive rule revisions that no one regulator wants to own or introducing new regulators struggling to position their agency as authorities but uncertain as to how to approach the role.

Institutions bristle at the lack of direction and clarity from regulators. All the document changes, confusion, and new “guidance” continue to distract lenders from their customer focus and inhibit their ability to grow portfolios. Meanwhile, the newest regulator—the Consumer Financial Protection Bureau (CFPB)—seems determined to revisit past concerns, such as indirect auto finance, mortgage servicing, and collections, adding to lenders' uncertainty, depleting resources, and threatening the auto finance ecosystem.

Most importantly, uncertain compliance requirements and tighter compliance deadlines impact IT and operations resources trying to implement new rules and guidance, which significantly adds to the lender's costs. Lenders high on regulators' “most troubling” list do not have the resources to comply, help improve processing, and move ahead with growing their businesses.

Risk

It is for all of these reasons that compliance and regulatory risk emerge as the top concern among all leading lenders in a recent Aite Group survey of executives from top lending institutions. Figure 2 shows that 95% of respondents believe that compliance and regulatory management is highly challenging. Interest rate risk (particularly in mortgage and HELOC lending) along with credit and liquidity risk also head challenge lists.

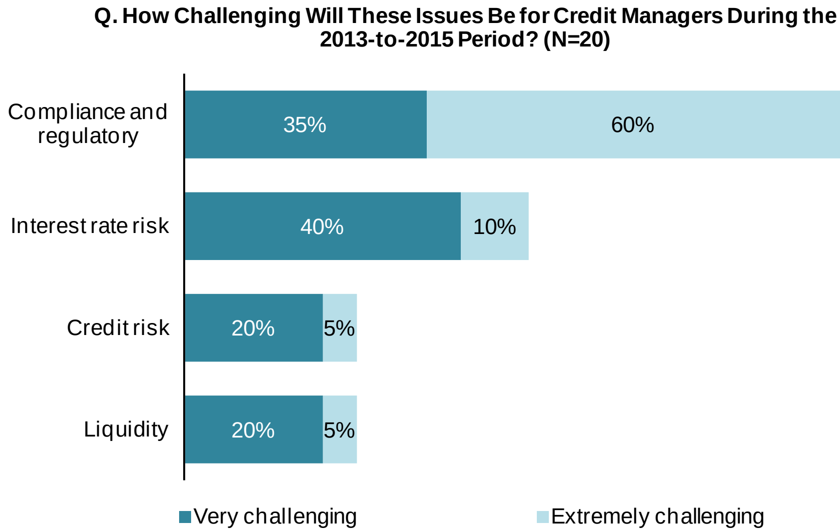

Figure 2: Top Lenders Gravely Concerned About Compliance and Interest Rate Risk
Source: Aite Group survey of 20 credit executives from top 50 U.S. lenders, February to June 2013

Lenders do tell us that moving forward they believe credit risk is much more manageable and in fact under control. However, Aite Group believes that competition, especially the convergence of new players in the marketplace, could radically change that. It could also lead to unflattering service comparisons and lost opportunities.

As an example, Quicken Loans is a mortgage finance company that built its business on its speed of delivery and frequent customer communications, and it topped J.D. Power's customer satisfaction survey for three years running. In the auto finance space, Ally Bank (formerly GMAC) lowered its fund costs by taking in US$45 billion in deposits and loans for its bank. It also provides application processing support for multiple captive finance companies, and it originates its loans online.

And because of growth in new-car sales, banks that had previously left the indirect auto business have returned to the marketplace. Other banks with leading share in financing new- and used-car sales at dealerships launched subprime subsidiaries to capture more profitable and higher-risk loans. This moves the capital risk offline and allows the lender to provide a convenient credit resource to the dealer.

Increased competition for new customers can push lenders to take inadvisable risks with credit products, policies, or pricing. It is more prudent to learn from competitors and, in particular, to look at how they leverage technology for flexibility and speed in delivering products and services. Competing with aggregators? Think like them.

Opportunities and Challenges

What is clear from all this is that in the credit market opportunities and challenges can be difficult to distinguish. There are possibilities for growth in three different product segments:

- **Auto finance**: New car sales are on the rise and yet the numbers of dealerships have seriously declined creating fierce competition among entrenched auto lenders and new market entrants for the dealers' consumer business. U.S. automakers' captive finance companies are traditionally strong competitors, today face significant challenges ranging from liquidity to new owners. Auto leasing once the strength of captives has found new favor amongst banks that had essentially abandoned the product years ago.
- **Credit cards**: Consumers are responsive to in-branch, self-serve offers. Reasons for that include a demographics change where Generation Y has moved past the 30 year old mark, were very hard hit by the recession, and need credit. Banks deploy decision analytics and processing solutions to deliver the credit card in a matter of minutes resulting in a satisfied new customer. Frequently banks do require a captive deposit account and have been adopting debit card strategies such as taking payments on a more frequent basis to aid in controlling delinquency levels in high-risk clients.
- **Small Businesses** still need working capital loans and since the business owner is most often a consumer (or consumers) some of the favored credit resources such as HELOCS or refinances are no longer available. While there is still opportunity for community banks and credit unions we see the major reasons that these loans and relationships do not develop continues to be paperwork, long decision times, and missed opportunities to bundle products and services. Major competition is also emerging in the form of well-financed online powerhouses such as Amazonloan.com that are analyzing their business customers (merchants with products for sale on Amazon) for performance, etc. and offering inventory loans to preferred customers.

Auto Finance Returns

Most lenders will tell you that beyond the regulatory uncertainties, their largest challenge is to grow their portfolios—specifically by finding new, qualified loan customers. Customer retention is not as much of an issue for lenders (Figure 3). When asked specifically about their institution's auto credit portfolio growth, 50% of respondents to a recent Oracle/Aite Group webinar say that attracting new customers is their biggest challenge, while another 25% choose finding new products to offer customers.

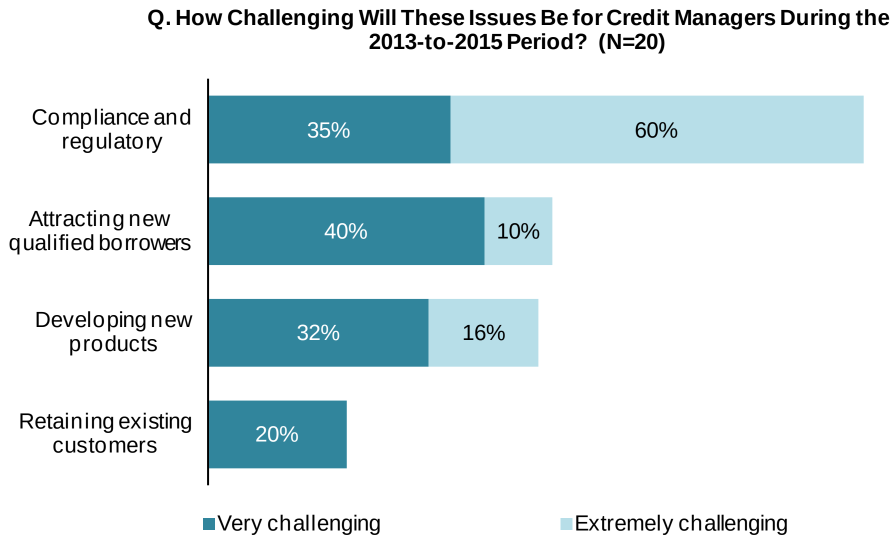

Figure 3: Lenders See Portfolio Growth as Critical, Attracting New Customers as Difficult
Source: Aite Group survey of 20 credit executives from top 50 U.S. lenders, February to June 2013

In the consumer credit world, Aite Group believes that the best opportunity for new credit customers comes from auto finance. Automobile finance comes in two flavors: loans, and leases to consumers.

Why Auto Finance? Because Consumers Are Buying It

Post-recession, automobile sales overall are on the rebound, and major reasons include such diversity as new-product development by automakers, affordable interest rates, longer-term loans, lender eagerness to tap the used car and subprime market for more loans, and a lack of used cars providing a new opportunity for sale of off-lease vehicles. Key components of this resurgence include the following:

- Rebranding and new designs are helping to increase new-car and -truck sales. No longer do all automobiles look alike.
- The franchised-dealer channel remains strong even with ongoing consolidations. And given the previously mentioned lack of self-lending alternatives, the indirect channel now delivers nearly 85% of new-auto loans to large banks and captive finance companies.
- Credit unions and their members remains the second-largest channel for new auto loans after the indirect channel.
- A large and thriving market in (used) collectors' autos. Financing sales at auto shows were until recently owned by HSBC and MBNA but is wide open today. Community banks in the right geographies (i.e., those with lots of shows) and strong online- and/or mobile-supported loan processes are well positioned to gather new customers. Inhibitors to traditional lenders are disruptive technologies, such as NFC, that enable devices attached to mobile phones to facilitate e-payments. The collectors' market is a segment where generational tendencies would work in a lender's favor—

this segment is usually an older person's venue, and older generations are more likely to trust a bank or credit union for payments than they are mobility and/or dongles.

In addition, there is consumer auto refinance and its initiation as well as its products refinanced is different. One is driven by credit unions and the other by consumers' attachment to self-lending and unavailability of HELOCS following the plunge in real-estate value. Credit unions have grabbed share of the auto finance market by refinancing other lenders' new-car loans. Typically, these credit unions move quickly after a new car and owner leave the auto dealer's lot, leveraging IT and external data to offer a new loan at a reduced rate almost before the new car is parked in its new driveway. This is a significant threat to dealerships' finances and to those lenders (in particular banks) that rely on dealer patronage for new loans and new customers.

It works well for credit unions, however, since most can provide lower rates because of their deposit strength and tax status. Usually a consumer does not have to be a member of a credit union to qualify but must open a demand deposit account (electronic payments are encouraged along with cost-cutting measures like online statements). Not many weeks after on boarding, all manner of loan opportunities, from credit card to refinance to HELOCS, are in front of the new member. For credit unions, share of wallet is their key focus—once they get customers, they keep them.

Other lenders have seen a rise in demand for refinancing of automobiles as well, though in this case, the automobiles are older and self-lending is the key driver. Automobiles last longer these days and, once paid off, often have respectable collateral value for borrowers that can be refinanced at an interest rate lower than most credit cards. Key uses for this include big-ticket purchases, college tuition, and the like.

Consumers Breathe New Life into the Used-Car Market

Post-recession, the used car market is really hot, and lenders see new opportunity there as well. Franchised dealers sell all the new autos, which means that the remaining autos available to be sold are used. Dealers sell cars taken in trade or at lease end, and even more frequently purchase cars at auction to augment a sparse inventory. Still, according to industry sources, 42% of the used cars sold in the United States (a total of more than 23 million cars in 2012) are delivered through outlets that do not sell new cars.

The number of these independent dealers with auto loans to fund (typically known as used car dealers) is increasing, and the number of large bank auto lenders launching their own subprime subsidiaries to capture this business is rising. Aite Group sees the following as areas of concern:

- **Rise in numbers of subprime originations and borrower debt**: Aite Group believes that by the end of 2013, the percentage of subprime borrowers will represent 15% of new loan account activity.
- **Increase of delinquency levels in loans funded by finance companies**: Post-recession, we noted that delinquencies on auto loans funded by finance companies began to surge upward in 2013 as the 2011 portfolios begin to season.

Hard Lessons Learned from Leasing

Although leasing is a financing mechanism in other consumer financial outlays (apartment rentals, etc.), it is usually only in the auto sector that leases have significant volume. The first Basel Accord, with its heightened capital reserve requirements on regulated institutions, accounted for leasing's initial popularity. A new auto-finance product built and launched by captive finance companies in order to balance funding requirements that were driving them from the loan market; leasing attracted consumers and seriously reduced bank lenders' share of the auto finance market. At first, leasing was remarkably successful. Fearing disenfranchisement and customer loss, banks jumped wholeheartedly into leasing in the early 1990s. The number of auto leases, which had never risen beyond 14% of cars a year, suddenly rose to 29% by 1997.

By 2003, the number of leases was declining rapidly and leasing had become an abysmal failure for a majority of banks. They had forgotten one of the 3 C's of credit: collateral. What do you do with the cars when the lease reaches end-of-term? Actually, this wasn't all they missed; there were no careful risk assessments or adequate systems to manage accounting for leases. Residual write-offs and later subvention of the manufacturers' incentives created further havoc, and it didn't do much for loan portfolios either. Many traditional auto lenders were increasing reserves and running off these portfolios pre-recession, while others were insuring their lease portfolios.

Those large banks that stayed in the auto finance business made sure that they had solutions in place to handle lease accounting, and they kept close watch on Web-based technologies and remarketers that enabled sales of pre-owned cars. Today, there is a manageable leasing market (estimated at about 15% of annual new-car sales), with almost all of it originated by captives and most often supported by franchised dealers eager to have an off-lease vehicles available to resell as “certified, pre-owned.”

It Really Is Hard to Tell the Challenges from the Opportunities

As the tale of leasing confirms, it is very difficult sometimes to distinguish between viable opportunities and opportunities with "danger" written all over them. One important example: lenders' propensity to set up subsidiaries to shield the parent from risk and safety/soundness concerns. Large, indirect bank lenders with market share and traction that have set up subsidiary finance companies need to be aware of the challenges, particularly since the subsidiaries' technology may not align with the parent's. The option of the subsidiary allows the primary bank lender to siphon off the "A" credit contracts and move all other applications to the subsidiary. Subsidiaries get first chance at the rest, and can, of course, charge higher loan rates because of the risk. These subsidiaries may also develop relationships with growing concentrations of non-franchised auto dealerships selling used cars to a growing class of subprime borrowers.

In all instances, it is important for lenders to recognize that caution is still necessary. This "subprime” ecosystem is remarkably similar to the mortgage subprime market and has all the attendant challenges. In auto finance, the dealers play a similar role to mortgage brokers and there are the same opportunities for application fraud if the appropriate credit, interest rate, and fraud technologies are not in place. It is not hard to believe that credit risk managers experienced in fraud prevention measures built into indirect auto finance solutions would have been positioned to question and remedy the lack of focus on fraud in the mortgage broker channels.

An additional benefit for many institutions is that when once-forgotten but still in-force regulations (such as the Soldiers' and Sailors' Relief Act) are integral to loan servicing solutions, they are unlikely to be overlooked. There is a reason that General Motors acquired AmeriCredit when it needed to support its dealers and had no finance arm except for Ally Bank. AmeriCredit had the technology in place to mitigate risk in GM's newly emerging indirect finance initiatives and at the same time, provide work flow and decision management tools for competitive positioning.

In the long term, auto finance is an extensible market and the potential remains for lenders to move into other areas of retail financing—boats, motor homes, motorcycles, ATVs, etc. But the challenges essentially remain the same. The financier has to be protected from the retailers and the consumers as well. Strong technology and analytics tools are keys to making indirect lending businesses grow beyond auto finance.

Technology Can Help

From 2008 to 2011, auto finance portfolio balances dropped more than US$500 billion. Unfortunately, during this same time period the numbers of loan accounts—while some were paid off and closed—remain essentially static. A significant processing pain point in the new normal is that while balances may have been charged off, the loan accounts do not disappear—they usually just move into collections.

In 2011, loan balances began to grow again, and they continue to climb steadily. All signs point to potential for new growth to continue in auto finance portfolios. Sales and loan balances are on the rise, and technology can be a key resource for all auto financiers. First and foremost, not just any work flow and decision engine will do for indirect origination. Strong, complementary adjudication tools to mitigate credit risk and guard against fraud—dealer fraud as well as identity fraud—are critical. But there is more.

More Work and Lower Returns

Lenders need to look beyond loan origination technology in order to understand ever-changing risk positions and individual product performance. Not only have buying habits changed, customers have definitely become more cautious in their borrowing. At the same time, a new generation of borrowers has grown up with online and mobile technologies. In 2013, the iPad is bridging the gap between online and mobile delivery. It already delivers signed and closed loans and reduces on boarding costs. Savvy lenders are electing to invest in anywhere, anytime IT options in order to attract new customers.

Beyond applications and new channels, we see evidence that lenders are pursuing electronic payments in efforts to reduce collection costs. We also see a good deal of interest in the adoption of mobile and online collections tools that segment and encourage self-cure and self-serve customers to manage their debt.

For many lenders, the approach to efficiency and portfolio growth continues to be tactical as they look for opportunities to differentiate and protect their brand, simplify their operations, and personalize products and services at customer level. In order to do this, the search is on for IT and tools that enable improved financial performance, specifically to:

- Find and fund qualified borrowers
- Process efficiently
- Deliver high-quality customer service
- Identify and retain customers with strong risk profiles

In the post-recession era, identifying and retaining customers with strong risk profiles can be very difficult, since fundamentally customers' behavior changed and good data is very hard to find. Two years ago, when Aite Group asked 20 credit executives from the 50 largest U.S. lenders what their primary technology focus was for 2012 to 2014 and they said they planned to grow their portfolios by focusing on customers, data management, and integration.

Unfortunately, two years later, they are telling us that regulations and compliance continue to intervene and stall most of their forward progress. New Aite Group research suggests that lenders expect to continue to struggle to grow credit portfolios organically. Figure 4 shows that 55% of top lending executives interviewed in 2013 think that improved data management and better systems integration are still a long way off.

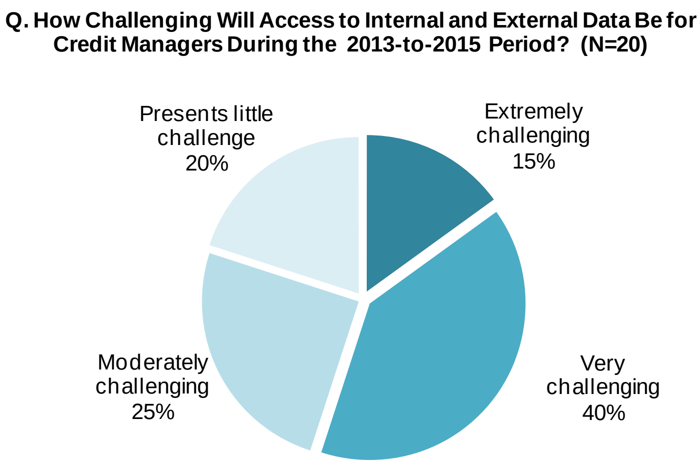

Figure 4: Concerns Continue That Data Management, Integration Need More Attention

Source: Aite Group survey of 20 credit executives from top 50 U.S. lenders, February to June 2013

Is Straight-through Processing the Answer?

Innovation has always been the hallmark of auto finance technologies, especially in automating paper-intensive, costly processes while keeping customers top-of-mind. Even during the early aughts, auto loan application and delivery IT set the bar high for both work-flow management and decision technologies. Adoption of new technologies linked partners electronically, eliminated paper and process delays, expedited decisions, plus embraced e-signatures and e-contracting.

The next logical step for auto finance was to turn attention to legacy servicing and collections solutions that while modified were often not positioned to take advantage of all the new features and functionality. At first, Web-based point solutions were thought to be the right answer but over time, with the success in other areas (for example, credit card online account maintenance, bank statements, etc.), lenders saw the benefits of connectivity in processing and cost efficiencies as well as in servicing customers.

For many lenders, straight-through processing (STP) has helped to speed response times, added the ability to identify customers with those good risk profiles, and delivered information to customer touch-points in real-time. Simplifying processes and making the customer's experience more valuable have paid dividends for many. And if a lender's consumer solutions are linked with a dealer floor plan, there is additional opportunity to view the dealer as a business customer and to bundle commercial and consumer loan services along with pricing and reporting—thus continuing to gather an enterprise view of all customers and the auto finance products' performance.

Overall, data integration and customer servicing work better on one platform while at the same time help improve pricing and define profitability. Most agree that STP ticks nearly all the customer management boxes. "Once and done" is always better, cheaper, quicker, everywhere and anytime.

Are We There Yet?

For most institutions, there is still a ways to go. Even so, many lenders are beginning to see progress, along with a new recognition that technology innovation is a powerful initiative for portfolio growth—especially today, when every customer counts, technology helps you keep what you have and get more.

There is a growing awareness among lenders that:

- It is well past time to embrace growth and efficiency initiatives that advance self-serve and mobility.
- Redesigning the process needs to be a recurring task.

Online aggregators succeed for a reason, and it is usually because they have discovered what customers need and have delivered what traditional lenders haven't.

The end game on the IT journey for many auto lenders is to deepen and interject transparency into customer relationships through timely access to data and quality analytics. Others with a roadmap that includes a safe expansion beyond auto finance into retailer markets will see technology as a valued partner and a key enabler.

Recommendations

Aite Group makes the following recommendations to consumer credit financiers:

- **Interject customers' needs into the credit technology equation.** Compliance cannot continue as the overwhelming focus of technology strategies and investments.
- **Leverage IT to rebuild the portfolio's value while protecting it from risk.** Auto finance is risky business, and indirect delivery increases that risk. IT that guards the institution's operational and

credit risk exposure, while at the same time leveling the competitive playing field with speed of response are must-haves for auto lenders.

- **Focusing solely on automating the origination process will not ensure success.** While it may bring customers in for a while, the end game is keeping the customers and improving wallet share.
- **Thinking like an aggregator can pay real dividends.** It is important, however, to remember not to lose sight of the customer in the pursuit of technology. Process efficiency and efficient service are the fundamental goals of enabling IT.
- **Enlist your IT provider-partners in your new business planning.** Ultimately, solution providers can be a strong source for strategy and a help with determining return on investments.

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