CRIF Select™

The Lender's Guide to Indirect Lending

IN THIS INFORMATIVE GUIDE, YOU WILL LEARN:

- Why indirect lending is such an effective growth strategy right now
- How auto dealers have changed in recent years and how those changes can fuel indirect lending success
- Three critical components of an indirect lending program
- Why you shouldn't believe every indirect lending myth that you hear
- The benefits of outsourcing indirect lending
- How to get started with indirect lending

CRIF LENDING SOLUTIONS

WHY INDIRECT LENDING?

Indirect lending is one of the most effective ways for a financial institution to grow its loan portfolio. That's a strong statement, and one that you've very likely heard before diving into this guide, but it's also a fact of doing business for financial institutions today.

So, why indirect lending? And more specifically, why now? It's all about the benefits.

Deposits have been on the rise and are on track to increase, which means there is a tremendous need to do more with these funds than just let them sit around collecting meager interest. Instead, financial institutions need to find ways to make those deposits increase the overall health of the institution. The fastest and most effective way to put those deposits to work is through an indirect auto lending channel. With a solid program, a financial institution can easily lend out on average of $1-$5mm per month at an average interest rate of 5 percent, which is a great way to use those deposits to generate growth for the financial institution. You're also able to lend out deposits at a higher yield than what you're able to make on investments, which means higher revenue and more growth for your institution.

Indirect lending is an all-around great way for an institution to generate growth because 80 percent of the business coming from this channel will be new member or customer growth. It's one of the fastest ways that an institution can add new accounts. Once you have the auto loan, you have the competitive advantage when it comes to capturing more business from these new members or customers. You also gain a competitive advantage with your existing customers or members by being where they need you, when they need you.

Increased market share is another great reward financial institutions reap from an indirect lending program. After all, if you are not out in the active market space where consumers are financing vehicles, you won't have a chance to capture any major piece of the market. The only way to capture market share is to actively engage and compete in the marketplace of auto finance. If executed properly, your institution could become one of the top lenders in your market. And if you accomplish this, your name as a lender will spill over into other products for your financial institution such as mortgage, credit card, small business and commercial lending, making the possibilities for growth nearly endless.

MAKING THE CASE FOR INDIRECT LENDING: THE EVOLUTION OF AUTO DEALERS

Of all the professions ever portrayed in movies and on television or generalized and stereotyped in conversations, car dealers have some of the worst reputations of all. And many financial institutions still are of the belief that "Dealers are only out for the sale; they don't care about my customers or members." Such thinking has led many institutions to shy away from indirect lending in order to avoid maintaining dealer relationships, but such avoidance means you're missing out on revenue and missing out on the ways dealers have changed.

The Internet has revolutionized the way we shop for and buy automobiles, which means dealers have had to change as well. Consumers today often have more information about the vehicles and inventory of a dealership than the staff of that dealership does. With knowledge comes power, and the consumers definitely have the power now.

In recent years, dealerships have had to make a big swing to compete for customer retention and service. Most of the staff members at a dealership are paid on commission. If they don't sell a car, they don't get paid. This used to create a feeding frenzy any time anyone walked into a dealership, and they would do anything to get a consumer to buy a car. In today's environment, dealerships know that every consumer has done research and homework before they even step foot in the dealership, which has changed the sales approach entirely.

Auto dealers are also master marketers and slaves to marketing analytics, so they fully understand that there has been a shift in consumer buying. Where consumers used to expect a transaction, they now demand an experience. So, dealerships are now very focused on creating an experience – and a positive one, at that – for each of your customers or members. There are now many dealerships that have cafés located in the shop for customers to use the Internet, have a snack or coffee, or watch TV while they wait. And these same dealerships are also active in serving the very same community that you are with your financial institution. In short, you share customers or members with your local dealers and they're out to deliver to those individuals the same level of superior service that you are.

So, don't let a distrust of dealers and their treatment of your customers or members cause you to miss out on an opportunity to grow your business through indirect lending. Smart dealers have evolved to meet customer demands, which means it might just be time for your loan portfolio and your thoughts on indirect lending to evolve too.

THREE CRITICAL COMPONENTS OF AN INDIRECT LENDING PROGRAM

With any type of lending program, there are the nice-to-haves and the must-haves, and an indirect lending program is no exception. To have a successful indirect lending program, here are the three critical components you should focus on:

1. **Relationships with Dealers** – Dealer relationships, like any business-to-business relationship, are driven by trust and experience. When you're building a network of dealers to funnel loan applications to your institution, you need to make sure you have the ability to form a strong relationship with each dealership's staff. And it isn't enough to just build a relationship with the F&I staff; make sure you take the time to get to know the sales manager and the principal or owner too. Dealerships are large and complex organizations, and getting to know the staff and gaining an understanding of the work they do and the stress they face goes a long way in gaining a great resource for auto loans.
2. **Consistent Buying -** One of the most important aspects of working with dealers is that they feel comfortable sending an application your way. The easiest way to achieve this level of comfort with dealers is to follow the program that you promoted to them. Keep in mind that most dealers have anywhere between 20-50 lenders that they can send applications to. So, if you promote a program to them and they submit applications within the program outline, but you then decline, condition or counter every application that comes through, the dealer will very quickly move on to another lender.

BEST PRACTICES: MANAGING DEALER RELATIONSHIPS

- Work with several contacts at each dealership. Finance, sales and office managers are all important.
- Offer constant communication and quick response time to your contacts.
- Know your contacts. Go out of your way to talk about something other than business.
- Know your dealers. Some are focused on volume and others are more interested in providing better service, but typically charge more for the cars they sell. Your program will appeal to each a little differently, and should be marketed just as differently.
- Find your niche on your rate sheet and promote it.
- Do dealer visits regularly. "Out of sight, out of mind" means this should be a regularly scheduled task.
- Ask your dealers questions to learn their side and make your program better.

Also, if you have multiple buyers, make sure there is consistency between them. The bottom line is, if you buy an application on Tuesday, you need to buy that same application on Wednesday, Thursday, Friday or Saturday. If you won't, your institution becomes too risky for the dealer, and they will simply turn to your competition.

3. **Efficient Funding** – This is critical. Following the recent financial crisis, creditors have tightened up on the floor plans issued to dealers. So dealers need the money for every funded loan as quickly as possible. This means, in part, that contract compliance issues need to be resolved quickly – granted they originate at the dealer, but your staff should be responsive to any issues that arise and work with the dealers to clean up those issues promptly. Once contracts are ready to fund, get the funds to the dealer as fast as possible. The executives of the dealership aggressively manage their receivables and if you as a lender are aggressive when it comes to getting their money to them, you gain an incredible competitive advantage when it comes to application capture at the dealership.

FOUR INDIRECT LENDING MYTHS - BUSTED!

Despite indirect lending's popularity among banks and credit unions alike, there are still several indirect lending rumors that persist in financial institutions today. Here are four of those myths, why they shouldn't discourage you from embarking on indirect lending and why outsourcing could be a viable option for your institution.

1. **Indirect portfolios don't perform as well as direct.** - Most indirect loans are from customers or members with no existing relationship with your institution, which isn't always a bad thing. If there's no previous relationship, there are no influencing factors when it comes to underwriting a loan. Most institutions are hesitant to approve borderline loans from individuals who aren't existing customers or members, so they end up putting higher-tiered paper on the books with indirect lending. Secondly, financial institutions will often choose to offer lower rates or rate discounts on their direct loans to boost that business and member or customer satisfaction. At the same time, this causes the institution to earn less yields on direct loans, thus diminishing that portfolio's performance.

2. **Only large financial institutions can compete in indirect lending.** – There are three critical components to a successful indirect lending program: Dealer relationships, consistent buying and efficient funding. If a lender can effectively handle all three of these areas, regardless of size, they will have a robust program. Smaller credit unions and banks may find that they need support in these areas, though. An indirect lending program takes know-how that smaller institutions may not be able to afford to have on staff, so outsourcing some or all of these indirect lending functions can create a competitive solution.

3. **Examiners don't like indirect lending.** In many cases, it isn't that examiners don't like indirect auto lending. It's that they don't like walking into your institution to see that you don't have any program processes in place, you're making too many exceptions to your credit policy, you don't have any on-staff program expertise, and you're getting all of your business from one dealership. These are all very legitimate red flags to raise, and a reason to consider outsourcing your indirect lending program to a company that can facilitate your program and provide you with program outlines, dealer management and expertise. In any outsourced situation, be sure that it's only a facilitation of your program, however, and that you control how loans are underwritten.

4. **Running an indirect program in-house is cheaper than outsourcing.** – Some financial institutions try to run their indirect program by dedicating half of a staff member's time to managing the internal logistics and sending a marketing person out to manage dealers, which is a recipe for indirect lending program failure. In order to effectively manage dealer relationships, process loan packages, resolve compliance issues and get money to dealers in a timely fashion, you need people dedicated to your indirect lending program. In these lean staffing times, it's unlikely that you have such individuals already on staff and difficult to justify the expense of adding staff, so outsourcing is often the most cost-effective option.

FOUR BENEFITS OF OUTSOURCING INDIRECT LENDING

An indirect lending program is one of the most effective ways for credit unions and banks to grow their loan portfolios. But for some financial institutions – perhaps because of constraints on time or staffing resources – establishing such a program can be nearly impossible to achieve internally. That doesn't mean that your indirect lending dreams can't become a reality, though – outsourcing an indirect lending program is a very viable option with great benefits, including:

1. **Managing Costs -** When you outsource your indirect lending program, you don't need a large internal head count to have a robust program. You also don't need to spend money on a technology system to support your program; with outsourcing, the technology and the service are both included. Without the cost of staff and a lending system, you can earn more overall yield on your auto loan portfolio.

2. **Focusing on Growth** – Every type of lending program requires day-to-day attention, including indirect lending. When you outsource your indirect lending, however, you don't have to worry about the daily processing functions associated with an indirect lending program. That means you can spend your time focusing on growing your program via marketing, dealer incentive programs and other indirect lending growth strategies.
3. **Easily Navigating Changes in the Economy** – Outsourcing an indirect lending program is a great way to weather uncertain economic times. With outsourcing, you don't have a large internal staff to worry about if the market takes a turn for the worse. Conversely, you also don't have to worry if the market booms, because there are economies of scale with outsourcing that allow you to not be affected from a resource and technology perspective like you would be if you ran the entire program in-house. You also get the power of a partnership, and can leverage the combined expertise to compete at a higher level, in good economic times and bad.
4. **Stricter Adherence to Program Policy** – When you outsource, your vendor should be facilitating your indirect lending program. That being said, they don't have the decision-making bandwidth with your credit policy that you would have internally. So there is a much stricter adherence to your credit policies, which will make your examiners and your compliance staff happy, and will result in a higher performing portfolio.

HAVE YOU CONSIDERED LEASING?

If you're looking for a natural next step to build on your indirect lending program success, consider leasing. Here's why:

- Compete in the new car market
- Capture A+ borrowers
- Earn higher yields
- Lease runoff averages 36 months
- Offering more options at the dealership means more business

GETTING STARTED WITH INDIRECT LENDING - THE CHECKLIST

Now that you know all of the benefits of indirect lending, the critical components of a solid program, the myths that you should simply ignore and why outsourcing might be the indirect lending solution you're looking for, you probably can't wait to get an indirect lending program started at your institution, right? If you answered "Not quite" to that question, you're not alone. The fact of the matter is that starting an indirect lending program can be overwhelming. But if it's done properly and is well organized, indirect lending can easily become the greatest loan volume channel at your financial institution. Follow these steps to help organize your efforts and simplify and expedite the process of starting an indirect lending program.

1. **Choose a partner or technology to start your program.** When it comes to indirect lending solutions, there are a lot of different options available to help you get started. You can choose a full-service partner that you can outsource your complete program to, or you can select a technology provider that offers a loan origination system for processing indirect loans. In addition, credit unions have the option of joining a group program that's already in place in their market, which can be an especially effective way for smaller credit unions to compete in indirect lending. Regardless of what you choose, though, make sure that you are connected to your local auto dealers via DealerTrack and RouteOne; it's a must-have for indirect lending success.

2. **Form your program.** In order to succeed in indirect lending, you need to know what success – and failure – looks like in your market. Take an opportunity to take a look around at what your competing national banks, regional banks, captive finance companies and state and local credit unions are doing in the indirect lending space. Once you know what's going on outside of your institution's doors, turn to your internal team. Have conversations about your goals, and make sure they are reasonable. Determine how you want to structure your program and what your niche will be. Whether it is through your rates, reserves, term or even advance or back-end, establish how you will set your institution apart.

3. **Create your rate sheet.** Your rate sheet is your top tool for selling and explaining your program to local dealers, so you want to take the time to make sure that it is a thorough document that includes:

   - Hours available, if favorable
   - Details describing any restrictions, including clear language regarding eligibility requirements and rate dates (e.g. Rates good January 1-15, or effective with applications starting November 1)
   - Title address, contact phone numbers and e-mail addresses
   - The amount of your institution's dealer reserve, as well as a clear list of your institution's tiers, LTVs and terms
   - A list of current promotions

- Where to send applications (e.g. your institution's logo or language like "Find us on DealerTrack")

- Program guidelines including the amount of advance based off of MSRP and NADA retail, the credit bureau your institution will use to pull credit reports, any vehicles that are excluded from your rate sheet, the minimum amount that can be financed, the maximum allowable mileage on vehicles, and whether or not you require references

- Back-end and product information including the warranty cap, gap insurance cap and descriptions of any acceptable add-ons

- Contracting and funding information that outlines where to send the funding package, any policies and procedures to be aware of, and any special requirements

4. **Get dealerships.** You knew it had to come to this at some point – it's time to get out there and start signing up dealers! Before you hit the road, create a dealer agreement that outlines your policies and procedures. Make sure it protects you from issues that can arise in indirect lending such as fraud and straw purchases, and that it outlines dealer obligations and logistical matters. Then, get out there to your local dealerships and explain to them what your advantages are.

5. **Manage your program.** Indirect lending isn't a "fix it and forget it" program. You need to manage your numbers, your loan volume, your LTVs and your liquidity. And most importantly, you need to manage your dealer relationships.

6. **Improve your program.** Finally, remember to continue growing and improving your program. Don't allow your institution to be complacent or satisfied with your current performance. Markets are constantly evolving, so make sure you are too.