**Auto Finance**  
The Competitive Landscape and Opportunities for Adaptation  

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**The Current Environment**

The current environment for the auto finance industry shows some significant trends:

- Banks have plentiful low-cost funds resulting from continuing high deposit levels following the flight from equities in recent years,
- A broad and deep asset-backed-security (ABS) marketplace is providing plentiful low-cost funding,
- Captives continue to offer 0% APR programs even on new models and sometimes with extended terms; cash incentives are less prevalent,
- A wave of consumerism, including litigation, is attacking the indirect pricing model,
- On-line application entry portals are lowering origination costs and increasing competition,
- Credit unions are becoming more active with new technology for indirect lending,
- Sub-prime sources are expanding and becoming more stable, and
- Prime providers are partnering with sub-prime providers to provide seamless point-of-application service.

Auto financing sources should be exploring how these trends are affecting all players in the auto financing industry.

The sources of funding available to dealers have expanded and matured. The automotive captives continue to compete with expanded incentives. Banks, despite having a lower cost of funds versus their captive competitors, have had to learn to compete on new grounds – more used volumes, extended terms and sub-prime alliances. What used to be a volatile set of sub-prime auto financing companies has turned into a solid group of sub-prime/non-prime auto financing sources with big corporate names as well as a deep and stable securitization funding market supporting them. Credit unions, once considered tiny fish in the pond, have turned into formidable competitors as they seek to capitalize on higher yielding auto loan assets made more readily available with new technology solutions and platforms. Plentiful bank funding availability has spawned a host of behind-the-scene buyers of auto loan portfolios in the major banks. And these buyers, through investment bank conduits, may not even be involved in indirect auto financing.

The product mix – direct and indirect, new and used, retail and wholesale, lease and balloon, financing and refinancing – has been evolving along with the changes in each financing type. The goals of the ownership base of an auto financing source, its operational capacity and its relations with customers, dealers and industry partners are driving this transition.

Technological changes in the auto financing industry are causing gradual shifts, some in process, others in relationships. Electronic credit applications, auto-decisioning and electronic titling really do not revolutionize the system. Rather, they tend to streamline the sales and financing processes, sometimes eliminating the need for certain market players and creating opportunities for new ones.
In some cases, there are clear improvements in efficiency and performance introduced by new technologies, including credit application turnaround time and dealer funding. In other cases, it could be argued that the technology and processes have not changed as dramatically as has the number of players executing the processes.

Over the last several years the introduction of dealer financing platforms providing the credit application and eContracting functions (between the financing sources and the dealers) have forced the need for auto financing sources to compete on different terms. Most of the service providers in the auto financing industry, including loan origination systems and loan/lease servicing providers have shown great flexibility in partnering with these platforms and becoming part of the new process. Other service providers, including DMS applications, credit reporting agencies and forms companies, have also had to adjust to the new environment.

Moreover, new data and/or forms of data, such as electronic vehicle configuration and used car values, have found additional uses in the auto financing side of the car business.

As financing has become more important in the automotive sales process, more attention has been given to the financing and retail process by legislators, regulators and consumer watch groups. Auto finance sources, especially the captives, and dealers are the target of numerous lawsuits ranging from alleged payment packing to bias discrimination. Automotive dealer and auto financing associations alike have had to seriously consider the alternatives to the core structure of the automotive financing industry. In response, an industry coalition among financing sources, their trade groups, dealers and dealer associations is working to increase consumer awareness and understanding of the financing process as well as to inform legislators and regulators of the value of readily available competitively priced in-dealer financing.

The management of each auto financing source must continue to evaluate the impact of these changes in the competitive landscaping and decide for their institutions the best way to adapt with technology, process, policy, procedures, and/or organization changes.

The Competitive Landscape
The marketplace in which indirect auto financing sources operate has essentially four different players; auto company captives, banks, credit unions and finance companies. In this marketplace, the role of the captive has grown among its peers and in the eyes of its Original Equipment Manufacturers (OEMs). The major bank consolidation and market exits appear to have slowed. The sub-prime/non-prime players are more clearly identifiable, though the spectrum in which they play has expanded tremendously. Credit unions have become a formidable competitor in the indirect and direct sales arenas. On the back-end, the type of non-traditional automotive investors purchasing auto portfolios has grown more diverse. The emerging partnerships among these players are creating an even more interesting stage to watch.

Captives
Retail APR and lease subvention programs and the emphasis on monthly payments have now clearly embedded financing into the purchase process, both in the mind of the consumer and in the dealers’ sales process. Finance and Insurance (F & I) products have become a key component in the dealership profit calculation. And, with dealers finding it hard to ignore the OEM/Captive joint financing offerings, the auto financing source selection process itself has changed.

Ask any non-captive auto financing source about whom they think owns the indirect auto finance market right now and they are all likely to have the same answer, “captives.” They would add that the captives presently enjoy a significant advantage due to the exclusive subvention programs with their facing manufacturers. As a result, some captives are contributing impressive profits to their OEMs’ bottom lines.

However, it would be a fallacy for any auto financing source to assume that they cannot compete with the captives. In fact, cash alternatives offered in lieu of incentive rates represent the most common opportunity that non-captive competitors can exploit. Consumers have shown a tendency to opt for cash rebates and
seek standard rate financing through non-captive sources in the current low-rate environment. This solution can prove particularly advantageous for high-credit-quality applicants who have access to low standard-rate financing, particularly if they intend to make any meaningful amount of cash down payment.

In response to this trend, some captives have begun to offer additional rebates with the express intention of providing a means to recapture finance contract volume previously lost to other sources. These include innovative programs with a guarantee of low rates on future renewal contracts, offering customers the ability to lock-in rates, similar to a mortgage, free auto insurance with a purchase or lease, and incentive rates for limited periods to extended terms (in excess of 60 months) contracts. While the success of these programs have yet to be fully proven, there will likely be more programs and features introduced with the same intentions of capturing greater loan and lease volumes.

In a more strategic move to keep control of more of their parent companies’ customers for customer relationship management (CRM) purposes, many captives have declared their intentions to cautiously move back towards purchasing larger shares of non-prime/sub-prime contracts. Previously, captives retreated from purchasing marginal quality contracts at the onset of the current economic downturn. Captives that have announced their intention to pursue more of this business have stated that they intend to do so with a keen eye towards profitability by focusing on a select segment of sub-prime customers and structuring offerings to mitigate potential losses.

In a similar manner, some captives retreated from the used car financing market in order to devote available capital to supporting their manufacturers’ new car sales. But other captives have recently announced plans to expand their used car financing efforts as an additional source of contract volumes and revenue.

Additionally, several captives have lately been bullish on leasing because of its higher loyalty value to their parents’ products. Particularly in the face of rising rates and an improving used car market, leasing may provide an attractive alternative to retail financing. While leasing is not expected to return to the levels observed in the late ‘90s, it may become a larger force and captives will likely be a driving catalyst in its return.

In general, captives have remained in the game – indirect auto origination is largely all they do. They have benefited from manufacturer-funded subvention efforts, adequate low-cost ABS funding and supportive parent CRM strategies.

Banks
Bank direct auto lending continues to decline in share as in-dealership processes become more convenient, speedy and price-competitive. As bank indirect lending seeks to match or beat captive programs, options for customers at the dealership are often more attractive than what would be available at the bank office. However, even though traditional in-bank direct auto lending is declining, the trends in the industry are affecting direct and indirect lending in many of the same ways.

Banks’ indirect lending strategies have been less uniform than those of captives. While the large bank players have generally held a steady course or have undertaken expansion initiatives, some banks, particularly smaller, regional players, have opted out of the indirect business. Some have sold existing indirect portfolios. One uniform trend among banks, however, is their concentration on prime credit risks.

Larger players have capitalized on the opportunity provided by rebates and have successfully offered attractive buy rates for high quality customers that, when taken in combination with a rebate, often provide a payment advantage over low APR programs.

The captives’ retreat from used car financing has provided an important opening for banks as well. Many banks have courted high quality customers purchasing late-model used vehicles.

Banks that were very quick to abandon leasing in the face of the residual value crisis seem to be the least likely to quickly return to leasing. Some bank players have never left the leasing arena and, like
captives, seem poised to capitalize on a potential resurgence in leasing fueled by rising interest rates.

Looking forward, the national players with substantial infrastructure will continue to make indirect auto financing a significant part of their total book of business. Among those that never left the field, some are making ambitious plans for expansion. Regional lenders that withdrew from indirect auto financing appear to have adopted a wait-and-see attitude with respect to returning to the indirect marketplace (though undoubtedly, a strong resurgence in non-captive lending will draw some of these institutions into a return to indirect lending).

Other banks may choose to balance their asset portfolios through ABS investing or by purchasing auto loan assets either directly, through conduits or through other developing funding mechanisms.

The growing bank appetite for auto loan assets originated and serviced by others – mainly the captives is another emerging trend. Asset purchases, rather than ABS investments, provide banks with higher yields (and risk) and are a very attractive alternative to other investment opportunities for the banks’ large deposit bases. This marketplace is growing through both private and public transactions. Many banks are using this marketplace as an alternative to growing their own indirect auto loan operations.

Finance Companies
Finance companies, traditionally associated primarily with sub-prime lending, have faced a tumultuous reversal of fortune. In the late ‘90s, many sub-prime auto financing sources were the darlings of the capital markets, as their asset backed securities promised high returns. During the economic downturn, the amount of defaults in these risky portfolios skyrocketed and sub-prime auto financing sources quickly fell out of investor favor.

As some of these auto financing sources have recovered from their capital crises, they have achieved operating stability and many have crafted plans for renewed expansion. In some cases, these plans include offerings designed to attract prime quality customers, cross-sell their portfolios within their parent companies’ divisions or grow their non-traditional direct business particularly over the Internet. The ABS marketplace has been particularly good for these companies by facilitating this growth.

The most significant development among these sources is the growing number of partnerships the auto financing companies have forged with prime finance sources. Their goal is to provide their dealer customers with quick, effective financing solutions across the entire credit risk range. Some of these arrangements are actually with banks and finance companies, some are with captives and finance companies and some are even within the same company. One of the most significant consequences of this trend is its impact on the dealer value equation for those financing providers that previously offered (or did not offer) a full spread of risk financing. This is no longer a differentiating factor.

These strategies make it evident that finance companies will provide a source of increased competition for captives, particularly as captives return to the sub-prime segment, and for all indirect auto financing sources as finance companies push harder into the prime quality market.

Credit Unions
Credit unions represent the largest probable new source of competition in indirect lending. Credit unions have become a popular alternative to traditional banks for many consumers during the recent waves of bank consolidations. Credit unions have long been a force in direct auto financing by offering their members quick approvals, generous terms and attractive rates.

Recently, credit unions have increasingly transferred this strategy to an indirect channel by ingratiating themselves with dealers through traditional field sales tactics and capitalizing on emerging loan origination and risk rating technologies being developed specifically for the credit union industry. Both credit unions and dealers report that these efforts have yielded a viable alternative to banks, captives and financing companies in the indirect lending segment.
Internal Environment – Opportunities For Adaptation

Regardless of what camp an auto financing company is in – captive, bank, finance company or credit union – they are likely facing increased competition for indirect auto financing business. Captives bemoan the tendency of customers to take cash rebates in lieu of special Annual Percentage Rates (APRs) and pair the rebates with low bank standard rates. Banks feel powerless to compete with zero APR programs offered by captives. Credit unions are daunted by the market presence of entrenched banks and captives, while finance companies struggle to create a niche in the prime quality market amid the same forces.

The growth of lead generation programs, including the Internet and credit-generated leads within dealer organizations emphasize the role of financing, once again, especially in the non-prime arena. The infiltration of CRM offerings into the auto financing arena is yet to be clearly defined though, as indicated earlier, several major auto financing sources are testing out these grounds. Auto manufacturers are keen to find ways to retain their customers. Most all captives have established either banks or Industrial Loan Companies as platforms for expanded CRM activity.

There are several key areas in which to focus operational effort that will help to assure a more effective response to increasing competition within the indirect lending marketplace.

Responsiveness

Auto financing sources have traditionally viewed speed to answer (the interval between receipt of an application and communication of a decision) as a key determinant of capture rate (the percentage of applications ultimately converted to booked accounts). While there is a logical connection between these metrics, the findings of our recent Auto Finance BenchMark Study showed no differentiation between speed to answer and capture rate. This situation was the result of all auto financing sources achieving relatively quick turn-times and suggests that once an auto financing source achieves a certain minimal turnaround time, there is little to be gained in terms of capture rate from further improvement.

This finding is of critical importance in today’s environment. For auto financing sources with long turn-times, they should immediately focus efforts on reducing their turnaround to be on par with competitive turn-times. For auto financing sources with “competitive” turn-times, further reductions may not yield the benefits they would expect. They may be better off to maintain their turn-times and devote resources to other process improvements. BenchMark’s finding also highlights the fact that on-line application entry portals are now the industry standard and one cannot play effectively in the indirect marketplace without that capability.

Auto-Decisioning

Auto-decisioning technology is a common means by which auto financing sources reduce their turn-times. As previously mentioned, this effect may not be auto-decisioning’s greatest implication for competitiveness. From the dealer/customer viewpoint, approvals obtained outside the normal financing source office hours and the breadth of application processing and funding are the biggest benefits.

Auto-decisioning is also a key means by which an auto financing source can redeploy resources from easy-to-decision deals to marginal credit deals. The idea is to minimize labor devoted to evaluating offerings which should clearly be approved or obviously rejected. Auto financing sources which seek to maximize their use of auto approvals and auto declines can free additional resources to focus on the in-between deals. This ability to quickly and accurately decision marginal credit deals can create a true advantage.

Evaluate Terms of Product Set

Several auto financing sources have been implementing initiatives aimed at improving the service they provide to dealers. In addition to the traditional notions of dealer service, like call-back time, dealers continue to express the need for attractive product sets that meet their needs.

Auto financing sources seeking to combat increased competition must evaluate their current product sets in terms of advance (loan to value)
and maximum term, in addition to pricing. For example, credit unions have traditionally been associated with offering exceptionally generous terms, in addition to competitive pricing. Maximum advance and maximum term (particularly on used vehicles) will likely become increasingly important as the incidence of “upside down” trades increases and as auto financing sources seek to penetrate the used car market.

Technology
As many auto financing sources have adopted what were once cutting edge technologies, like on-line application entry, it becomes increasingly harder for auto financing sources to differentiate themselves and to “lock-in” a dealer relationship. In the case of on-line application entry, the technology was once a proprietary platform that offered some auto financing sources a competitive advantage over others – dealers could receive faster decisions by using on-line channels. Proprietary on-line application entry also helped to cement an auto financing source’s relationship with a dealer because it made it much harder to “shotgun” an application. The dealer had invested a certain amount of effort to enter the application, thus was more likely to exhaust all efforts with the chosen auto financing source before shopping the contract to different auto financing sources.

The prevalence of on-line application entry portals reduces this effect. Indeed, application entry portals may make “shotgunning” even easier and quicker, thus increasing competition between indirect auto financing sources. Emerging technologies, however, can have the same effect as proprietary application entry systems once did. It is also important that financing sources understand the relationships being formed between the new technology platforms and the loan origination systems and servicing applications as well as the dealer management systems. Auto financings sources should be aware of any potential partnerships impacting their operations and seek out any synergies that can be gained by these relationships.

The emergence of eContracting offers real advantages to dealers by reducing the float associated with contracts in transit for funding. Auto financing sources that adopt and successfully sell the advantages of eContracting have the potential to solidify dealer relationships and to deliver a competitive advantage that dealers can see in their bank statements.

The introduction of new data sources into the auto financing arena is worthy of exploration as well. These include vehicle configuration data and used car values which can be used in automating current operational processes.

Traditional Field Sales Channels
Traditional field sales channels, including regular dealer visits by calling officers and dealer events have long been a mainstay of indirect lending. Entrenched auto financing sources typically have well-developed field sales strategies and maintain regular presences in their established dealerships, while targeting new prospects face-to-face.

The field sales channel remains an area worthy of attention because it serves as a vital means of gathering competitive intelligence and dealer feedback. New market entrants, like credit unions, have successfully developed their sales channels and have received positive results. This means that dealers may have more calling officers from different auto financing sources visiting them than ever before.

Prime/Sub-Prime Alliances
As more sources form alliances, the ability to differentiate by spread of risk will diminish. When these alliances are transparently delivered through on-line application portals, they are most powerful and this may become the industry norm over time. Presently, most alliances have a single sub-prime party but that may change as competition intensifies. Unless a financing provider is comfortable with a very broad spread of risk and is organized to originate, service and collect such a portfolio effectively, forming an alliance is the opportunity to offer dealer-customers a full-spectrum purchase policy. The evolution of this trend will have a major impact on the marketplace by forging new competitive forces.

Collections and Servicing
Auto financing sources seeking to gain a competitive advantage by buying deeper into the credit quality spectrum must first build a solid collections and servicing infrastructure. Those that have developed a core competency in
collections can exploit this advantage to gain market penetration, while maintaining acceptable loss performance and margins.

For auto financing sources seeking to increase their share of lower quality bookings, it is imperative that they solidify their collections performance prior to implementing purchase policy changes. There is no clearer evidence to support this than the experiences of the sub-prime industry in recent years following their rapid expansions. Having their collections and servicing running gear in place ensures that an auto financing source will be able to immediately and accurately assess the impact of changing portfolio mixes. It also enables the auto financing source to stay ahead of loss trends by effectively managing delinquency and avoiding spikes in collection volumes that could otherwise result in unnecessary losses.

**Portfolio Management**

The growth of the auto loan asset marketplace will place increasing pressure on servicing operations to standardize and conform to regulations. As assets are packaged and sold, purchasers will require due diligence audits to assure them that consistent servicing and collection practices are being executed. Bank-purchasers will require compliance with OCC regulations, which differ from SEC requirements and are often more limiting. As standards for assessing loan risk are developed, standards for servicing will also emerge and servicers will need to conform and demonstrate that conformance. The workload associated with due diligence will increase and require careful management by both the purchasers/owners and the servicers.

**CRM**

The development of CRM strategies by the auto manufacturers may place additional requirements on non-captive servicers to provide additional similar capabilities for their customers. This may also be an opportunity for non-captives to increase their value to their dealer customers. And, it may provide insight into how finance companies, banks and credit unions can initiate their own CRM programs to increase the penetration and loyalty for their other financing products. These CRM programs may also develop into partnering opportunities to sell bank products to captive customers.

**Legislative and Industry Activities**

It is, of course, important for all auto financing sources to stay abreast of legislative and regulatory issues affecting their business. In addition, auto financing sources should be aware of industry activities involving responses to legislative changes. Whether an auto financing source chooses to respond on their own and/or to participate as part of an industry, it is important to explore all opportunities.

**Conclusion**

When viewed from the outside, the indirect auto lending market will likely become more crowded as new players enter and expand, while existing auto financing sources search for additional opportunities to grow their businesses. Captives and large banks are here to stay. Regional banks, finance companies and credit unions are seeking to carve out a new piece of the indirect lending marketplace for themselves.

Regardless of segment, these competitive forces have similar implications for operations. Sales and marketing functions may be forced to modify their field sales activities and their product offerings. Buying processes will face pressure to be responsive and to effectively employ technology to achieve optimal resource allocation and to cement dealer relationships. Finally, collections and servicing functions may require attention in order to form the necessary underpinnings to successfully execute growth and/or penetration strategies. These opportunities for adaptation, the byproducts of competition, will enable savvy lenders to capitalize on industry trends.
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