



The Excitement about the Non-Prime Auto Financing Industry

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Sub-prime financing (also currently referred to as non-prime) exists in the auto financing arena, in the mortgage industry, and in consumer finance. Questions about the sub-prime consumer and the growth of this market segment continue to surface. Who are the companies offering non-prime auto financing these days and are they healthy? Is the non-prime auto financing industry thriving? All indications seem to say "yes".

The questions being raised in auto finance today focus on the evolving nature of the players in the markets and whether there is a need to be a part of this spectrum of the non-prime industry. With the shrinking margins on the retail prime side and the residual challenges of leasing, the non-prime auto financing industry certainly has appeal. However, entering or partnering into the non-prime market requires more than pure desire. It requires solid experience and business savvy along with strong dealer relationships.

The Statistics

The non-prime market has grown. This growth can be measured in dollars or accounts outstanding, dollars or accounts originated, number of securitizations; or on more qualitative measures such as dealer satisfaction or the length of the dealer's relationship with its auto financing source(s). The ability to track these measures continues to improve.

Participants at the recent National Auto Finance Association's (NAF) 2006 Annual Conference discussed the figure of \$260 billion for the non-prime market size. The association's 2006 Non-

Prime Auto Financing Survey, conducted by BenchMark Consulting International, showed the average outstanding to be \$2 billion, up 22% from the previous year. Cumulative originations were \$31 billion in 2005, up 11% from 2004 and triple the \$10 billion in the 1997 survey. The study participants represented a majority of the industry's non-prime originations. In addition to increases in originations and outstandings, nearly half of the respondents securitized their portfolio; and those that did securitized 78% of their portfolios. It is clear that the non-prime auto financing market is growing.

The Players

Over the last ten years, the major players in auto finance have been indirect financing sources who made a distinct division between prime and sub-prime. Today, what used to be called sub-prime financing or special finance is more commonly referred to as non-prime auto financing. In addition, this non-prime segment is more specifically divided into such groups as near-prime, sub-prime, high-risk, and Buy-Here Pay-Here (BHPH). While the exact credit tiers that fit each type vary by auto financing source, there is increasing appreciation for the depth of work required to manage each individual tier. While many of the previous sub-prime players are no longer in business, there are many others that have grown strong and gained valuable experience. In fact, in observing the market as a whole, a strong class of non-prime market players has emerged.

Many large, multinational financial institutions are now participating in the non-prime auto financing

arena. This participation resulted from mergers and acquisitions, many of which involved a non-prime auto financing division (only incidentally) as a part of a larger transaction. For some, this means they have become a bigger, stronger non-prime auto financing company that has an even bigger, stronger parent company. For others, it means the ability to have a full-spectrum offering of products, i.e., the ability to offer financing at all credit levels from non-prime to prime. These larger players include Capital One Auto Finance, Chase Auto/Chase Custom Finance, HSBC Auto, Citifinancial Auto, Wells Fargo Auto Finance, and Wachovia Dealer Financial Services/WFS.

A number of other banks currently have or have had non-prime auto financing units within their operations in a somewhat more detached manner. For instance, BB&T owns Regional Acceptance, a non-prime auto finance company. Regional recently purchased FSB Financial, a portfolio purchaser of non-prime paper. In the past, Key Bank owned AFG, a non-prime auto finance company; and Charter One had bought Superior Bank (owned by Coast-to-Coast Financial) before being acquired by Citizens Bank (owned by Royal Bank of Scotland). Meanwhile, there are other banks that have simply bought deeper.

Two of the captives have also invested in non-prime auto financing companies. GMAC bought LSI to form Nuvel and then later acquired National Auto Finance Company. Both are still offering non-prime financing. Ford created Ford Fairlane to focus on the non-prime market, but closed it down after six years in operation. Ford also acquired Triad Financial but recently spun it off in a management buy-out.

Alternatively, some captives buy deep enough to be considered non-prime financing sources. Here, again, some have managed the greater risk more effectively than others. One captive's credit losses resulted in the sale of its portfolio to Merrill Lynch. Other captives have chosen to form origination partnerships with non-prime auto financing sources. This enables them to minimize risk while capitalizing on the market opportunity by providing an expanded financing offering to dealers - another good way to improve dealer satisfaction.

A handful of companies have carved out a niche within the non-prime market. WFS and Long Beach Acceptance have strongholds in the near-prime arena. There is more room than with traditional prime retail to make a profit and less risk than the more sub-prime market. The competition, however, can be tough as many of the prime players, captives, and banks continue to buy into this area.

Several of the non-prime auto finance players dedicated solely to the non-prime auto financing market have experienced difficult times. AmeriCredit survived rough times in the 1990's and has regained investor confidence. AmeriCredit's recent purchase of Bay View Acceptance, its announcements about growing in the U.S. market, and its reentrance into the Canadian market further demonstrate its staying power and its dedication to its dealers and shareholders. Likewise, under its new ownership, Triad continues to grow in both the indirect and direct auto financing areas.

Several other dedicated non-prime auto financing companies are nearing national coverage such as Credit Acceptance Corporation, First Investors (which purchased Auto Lenders Acceptance), Consumer Portfolio Services (which acquired MFN Financial and TFC Enterprises), and United PanAm Financial (also known as United Auto Credit Corporation). Others have a regional presence such as Crescent Bank & Thrift, Fireside Bank and Nicholas Financial. Still others have even smaller niches such as Affiliated Financial, Mission Financial, Marquette Consumer Finance and Westlake Financial.

Not to be excluded, credit unions have also been active in the non-prime market. This market has gone after the non-prime consumer and partnered with origination companies such as Centrix Financial. Although the National Credit Union Administration (NCUA) issued an alert last year, the alert was lifted and credit unions can now go back to competing for the same customers as the others.

Non-prime financing is not limited to the United States; there is movement in this arena in Canada, as well. A handful of Canadian players have continued to mature in their operations - the

biggest being Travelers Leasing, VFC (recently bought by TD Bank), CarFinco and Nelson Financial. In addition, HSBC Auto, Wells Fargo and AmeriCredit offer non-prime financing in Canada.

None of this is intended to say that all auto financing sources that have entered the non-prime market have succeeded. Many have exited the market or gone bankrupt – Jayhawk Acceptance, First Merchants Acceptance, Western Fidelity, Monaco Finance, are only a few examples of unsuccessful candidates. The successful players in this industry have done relatively well at learning from their mistakes as well as those made by their peers.

In contrast to what used to be simple classifications of prime and sub-prime, the new world of auto finance is a bit more complex. Non-prime financiers are playing in one or more credit niches, partnering with prime players to expand distribution, or simultaneously growing the non-prime and prime business lines with a full-spectrum offering.

	Super Prime	Prime	Near-Prime	Sub-Prime	High Risk
Prime Only		✓			
Prime w/ Non-Prime Partners	✓	✓	✓	✓	
Non-Prime Only			✓	✓	✓
Full-Spectrum	✓	✓	✓	✓	✓

Other areas where some non-prime players have chosen to expand their operations are direct auto loans and independent dealers. Several non-prime auto financing sources offer loans directly through their own websites as well as through affiliate programs. Moreover, a number of the non-prime companies are beginning to take another look at the independent dealer network as a distribution channel. Poor experience in the past caused many to abandon the channel. However, the opportunity with independents is presented, again, with non-prime financing companies desiring to expand volume and the independent dealers needing to secure additional financing sources.

Likewise, prime players are looking to grow the business. They can buy deeper (as far as near-

prime), they can partner with non-prime players, or they can provide a full-spectrum offering.

All of this clearly states that the market is not only quite active, but is somewhat crowded with multiple players with varied value propositions and product offerings. Prime and non-prime players moving in each direction within the credit spectrum coupled with new market entrants indicate the competition is expected to grow more intense.

The Customers

Understanding the behavior of the non-prime consumer (FICO scores of 600 or below) provides insight when structuring deals that would not traditionally be approved nor funded. Art Spinella of CNW Market Research in Bandon, Oregon, recently shared his findings on this group at the 2006 NAF Annual Conference:

- Non-prime consumers spend more of their disposable income and more of that spending is on “embellishments,” or the extra things in life
- Non-prime consumers tend to have had more jobs in the last ten years than prime consumers
- Non-prime consumers are less likely to have a college education
- Non-prime consumers tend to have more vehicles in their households but have a higher likelihood of having the need to replace one
- Non-prime consumers are likely to spend more time watching television and e-mailing and less time reading newspapers

Understanding the consumer demographics along with the purchase and payment behavior can help a non-prime auto financing company when marketing to a non-prime consumer, originating indirect or direct loans, providing customer service, or collecting on bad debt. Because of non-prime consumers’ credit histories, collection operations in non-prime companies must be significantly more diligent. It is this business acumen that will give a non-prime company a competitive edge.

Operational Readiness

Overall, the non-prime auto financing players are more sophisticated in their operations and use of technology than ever before. Experience, strong parent company support, expertise, and the ability to make more flexible and nimble decisions have contributed to this growing sophistication.

In originations, application processing has become largely automated in both the prime and non-prime arenas. According to the 2006 NAF survey, auto-declines grew, thus reducing the time it took to look at deals, overall. At the same time, auto-approvals decreased. This means auto financing sources are giving attention to dealers on the applications that have a better possibility of being financed - a good source of dealer satisfaction. A dealers' understanding of the buying practices of non-prime auto financing sources lends to the stability of the industry.

Platforms are available that connect auto financing sources with dealers to deliver online credit applications and electronic contracting in some cases. Several of the founders of these platforms, in particular, Wells Fargo, Chase and AmeriCredit, are among the largest auto financing sources offering non-prime financing. Almost all other non-prime finance sources utilize the DealerTrack and RouteOne platforms.

Many are also joining Finance Express, BigFNI and APPOne which focus on linking the auto financing sources with independent dealers. In Canada, Curomax, RouteOne and DealerAccess offer the same connectivity between dealers and the non-prime auto financing sources. And, in the credit union world, Centrix Financial provides services for some credit unions, and CUDL and Aimbridge provide the technology platforms for others.

Nonetheless, buying and underwriting skills are still crucial for survival. The experience of the current players, more sophisticated scorecards, and the expansion of auto decisioning have made these processes more efficient. Different underwriting criteria have been tested over the years by every player and there seems to be a growing comfort level at each auto financing source. Dealers' understanding of the buying

practices of non-prime auto financing sources lends to the stability of the industry. And, as in the prime arena, electronic document management is being implemented to improve workflows and processes, reduce errors and improve productivity.

Collections and recovery operations, core areas of focus in non-prime finance companies, have become more effective. With the successful management of dialer strategies and increased use of behavioral scoring, at least by the larger players, the art and science of collections are blending. At the same time, delinquencies have been largely held in check. The NAF 2006 Non-Prime Auto Financing Survey revealed that 2005 dollar and account delinquencies were down in spite of well-publicized shifts toward longer monthly terms. In the 2006 NAF Non-Prime Survey, 74% of the new car loans were booked with terms greater than 60 months.

Dealer Acceptance & Reaction

Dealers, of course, see this growth and stabilization as positive as long as there is financing made available for consumers in all credit tiers. The consolidation of players leaves fewer choices; however, the tougher competition among those left is perceived by dealers as healthy. Independent dealers welcome the availability of willing finance partners.

The key to success in this market is the ability to grow strong dealer relationships combined with a solid sales strategy. Building dealer confidence that the non-prime financing source will remain in the market long-term is difficult given the activity in this segment over the last few years. Reestablishing credibility is challenging when a player attempts to reenter after an exit. Furthermore, being able to understand the strength of a dealer and the level of profitability a dealer brings to the financing source is also critical. And, fighting against today's even tougher competition and more powerful players requires even greater focus than before to get to the top of dealers' minds.

Summary

Overall, the health of the non-prime auto financing industry appears to be recognized by all. The focus of the future will be on fortifying operational structures, risk management policies and activities to brace against potential economic and market fluctuations.

Nonetheless, the players in this market segment are learning from one another and maturing with the industry. With the right structures in place and an eye on the ball, the non-prime auto financing industry can be an exciting place.

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