Indirect Lending Rates & Dealer Reserves

November 2022

McQueen Financial Advisors

As interest rates continue to soar higher throughout 2022, we are surprised by the limited interest rate increases in indirect auto loan rates. In most cases, loan yields have not kept pace with the Federal Reserve's rate increases or the rising yield curve. Currently, we see many indirect loan yields in the mid 4.00% area versus our expectations of yields near 7.00%.

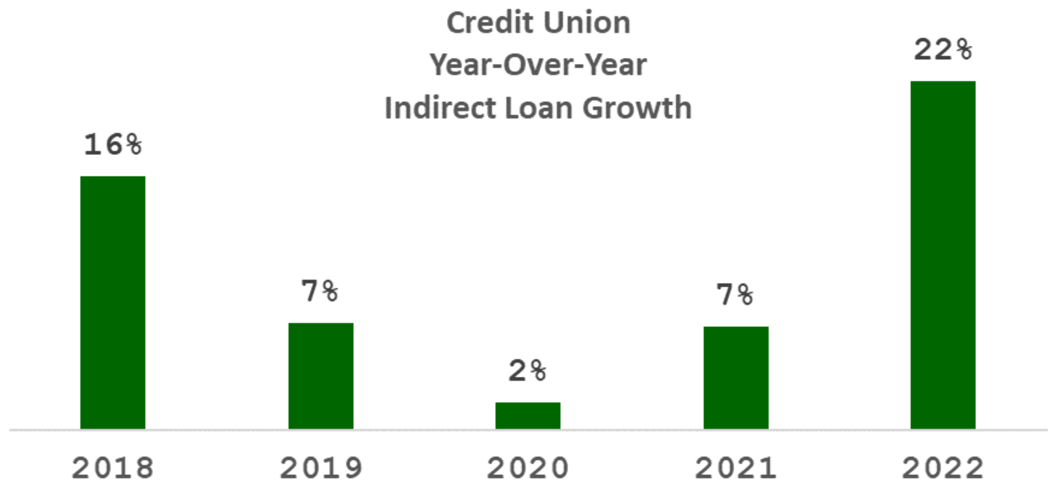
At the start of 2022, the Fed Funds rate stood at 0.25% and the 2-year US Treasury yielded 0.78%. Today, the Fed Funds rate is 4.00% and the 2-year US Treasury yield is 4.50%. The magnitude of the Fed Funds rate increase is significant, as the Fed has not increased the Fed Funds rate by 4 full percentage points in any 12-month period since the 1980s.

We highly recommend that you review your indirect lending rates and dealer reserves immediately.

"Loan yields have not kept pace"

Indirect Lending Growth

Indirect lending has contributed to strong loan growth at many credit unions. Across the industry, indirect lending is up 22% year-over-year (June data). Between June 2021 & June 2022, indirect lending was up a by a staggering $54 billion, compared to only $4 billion in 2020. The recent 12-month period has been the largest growth by far. To match the $54 billion in recent growth would typically take 24 to 36 months.



Indirect lending is growing much faster than total industry-wide lending. In the most recent year, total loans grew by 16% while indirect lending grew by 22%.

Indirect loans now represent 67% of total vehicle loans industry wide. This concentration of indirect lending has been climbing steadily for nearly 10 years, when it stood at 43%.

Where Has the Growth Come From
Historically, there have been four major indirect participants:
- Auto Manufacturer Finance Companies
- Auto Loan Trusts
- Large Banks
- Credit Unions

The market has quickly changed, and three of the four players are significantly reducing their volume, leaving Credit Unions as a much larger participant.

Auto Manufacturer Finance Companies
Auto manufactures have stepped back on lending as they are conserving cash due to the large amounts of "inventory" sitting in parking lots without computer chips.

Auto Loan Trusts
Auto loan trusts need a loan yield close to 7.00% to cover the cost of debt and the higher credit reserves with the elevated loan values. As a result, they have reduced their loan fundings significantly. Managers of trusts tell us that It is hard to compete with a mispriced lending..

"Three of the four players are significantly reducing their volume"

Large Banks
Large Banks have also reduced their volume as risk adjusted yields on car loans are too low to justify placing them on their books. We will discuss the net yield, dealer reserve and the elevated asset values in the next sections.

Three of the four traditional lenders are significantly reducing volume, and Credit Unions are taking on substantially more loans at lower than optimal rates.

Dealer Reserves
Dealer reserves are nothing more than a payment made to a dealer as compensation for initiating a loan. The amount typically ranges from 0.50% to 2% but we have seen some higher payouts.

We recommend that you reduce your deal reserves to the 0.50% area due to the high loan volumes.

Further, please review your dealer reserve amortization as the expected automotive loan term is typically 24 to 36 months. A longer amortization will result in a charge at the end of the loan.

Dealer Goals vs. Lender Goals:
It may seem counterintuitive, but car dealers don't make a great deal of money selling cars. To make up for this, they upsell a variety of products such as insurance, extended warrantees and financing.

The car dealer is incentivized to focus on two aspects of lending to increase their profitability:
- Obtain the largest dealer reserve possible
- Increase the size or amount of borrowing

Growth Goals & Concentration Limits:
It's important to set growth goals and concentration risk limits. As a percentage of total loans, we've seen some concentrations as high as 85%. This seems high to us, since indirect borrowers don't have strong ties to the credit union. If growth is happening faster than anticipated, there are two ways to slow the growth.

Method One: Raise the loan rate. A build up model for appropriate yields is important. Example:

"Car dealers don't make a great deal of money selling cars"

Component	Rate
Risk Free Rate	4.50%
Annual Credit Loss	0.50%
Dealer Reserve	1.00%
Credit Risk Spread	1.50%
Resulting Base Yield	**7.50%**

Method Two: Reduce the dealer reserve. By doing this the dealer will send loans to other lenders offering a bigger payment for the loan. On average we see dealer reserves being lowered to 0.50% today.

Critical Thinking
We have been told countless times that if an institution lowers their indirect dealer fee that they will lose the relationship with the car dealer. Over several years of working with credit unions we have proven this statement to be false. If you lower your dealer reserve and volume declines, that is good. If you raise your dealer reserve, your volume will increase. ***It is important to understand that the credit union is a tool that the car dealer uses to sell a car***. There may be a solid relationship with the car dealer and the credit union, but do not be fooled as a car dealer will send their loans to whoever is paying the biggest dealer reserve and who will fund the loan.

Loan Rates

We encourage lenders to raise loan rates now and to review risk-based pricing grids. The Federal Reserve's rate hikes throughout 2022 are intended to fight inflation but may result in a slowing economy. With this, we can expect higher delinquency and charge-offs.

We have measured the true yield of indirect loan programs for many clients across the county and often find yields that are lower than risk-free U.S. Treasuries, after accounting for dealer reserves and loan losses. Given economic uncertainty, our first goal must be earnings adequate to compensate for the risk imbedded in each loan. Additionally, CECL will require a full reserve at the time of booking the loan.

The Incremental Cost of Borrowing

With greater frequency, many institutions are experiencing liquidity stress. This stress is a combination of strong loan growth and deposit run off. Today's yield curve means that borrowing costs are high across all maturities from overnight to 10 years.

"Raise loan rates now"

As of early November 2022, FHLB term borrowings were available in the range of 5.00% regardless of term. In nearly all cases, borrowing to fund indirect lending growth will result in extremely low or even negative returns. This is simply because the cost of borrowing is so high relative to the net yield of indirect programs. Example:

FHLB Borrowing Rate	5.00%
Dealer Reserve	1.00%
CECL/Credit	0.50%
Break Even	**6.50%**

The above example shows the minimum rate that must be changed to break-even. This rate does not include the cost of putting the loan on your books or servicing.

Indirect Loan Risks

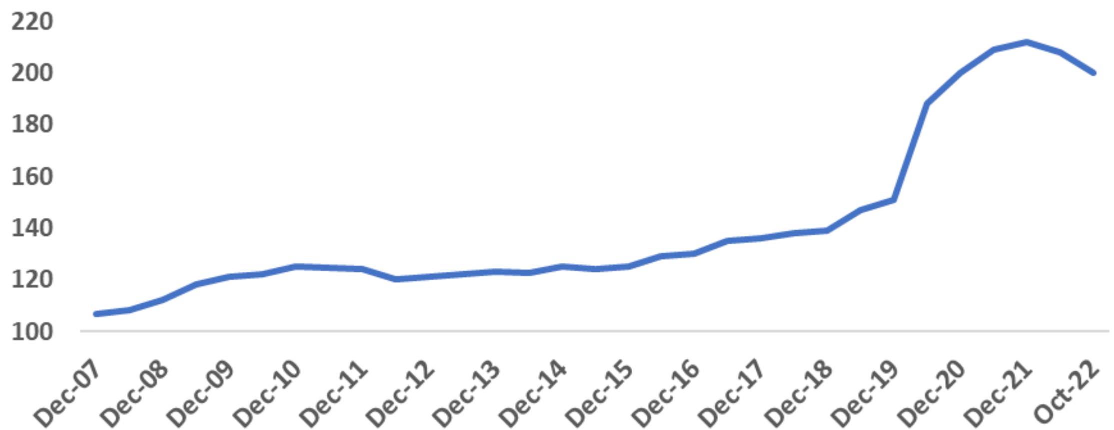
Seeking growth, some lenders have lowered underwriting standards, granted longer terms and offered higher loan-to-value options. Negative equity roll-overs have also become more common. The primary risk is that delinquencies will increase, and net losses will follow. Across the industry, the average auto loan charge off is in the range of 40% of the original loan amount. Loss severity has grown because cars are more expensive, negative equity is often rolled over and car values fall faster than loan balances.

Used Car Values

Manheim is the nation's leading provider of wholesale vehicle auctions. Auto dealers, car rental agencies, manufacturers and financial institutions buy and sell bulk autos through over 100 nationwide auction sites. Each year, over 6 million autos are bought and sold through Manheim's network. The index has skyrocketed higher in 2020 and 2021 with the lack of computer chips for new cars.

As new car production and chips are more plentiful, we are seeing a significant decline in car prices. This would lead us to expect higher charge off rates will be following. Used auto prices increased by nearly 33% during the pandemic and have already started to trend lower.

"High car prices may trend sharply lower"



We suggest the following:

- Raise loan rates to maintain a positive spread and control growth
- Review and reduce dealer reserves to control growth
- Review and update risk-based pricing grids
- Ensure proper loan pricing especially when borrowing to fund indirect programs
- Encourage dissenting opinions internally, and thoroughly consider all options, including slower loan growth
- ***Talk to your MFA Advisor about investment portfolio options in the current rate environment. Often, bond yields are higher than net indirect loan yields.***

We encourage you to talk to your McQueen advisor about your specific indirect loan rates, dealer reserves, borrowing plans and liquidity needs.