

The Rising Repossession Tide

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Summary

The First Quarter of 2008 brought to the auto finance industry a significant increase in delinquencies and repossessions, especially among finance sources with higher-risk portfolios. A confluence of market forces is driving up both workload and losses for most auto finance operations. Astute executives are asking their organizations, "Are we doing everything possible to avoid repossessions, and are we managing our processes appropriately?" This whitepaper analyzes the rising rate of repossessions and explores methods that organizations can use to cope with the flood.

Analysis

The economic turbulence associated with the sub-prime mortgage crisis, coupled with slowing economic growth, has many analysts speculating that the U.S. economy may be in a recession. The slight rise in consumer lending delinquencies evident at the beginning of last year is now surpassing five-year highs for some. According to statistics from the Federal Reserve's website, 30-day delinquencies at year-end 2007 were up approximately 17% from year-end 2006. In a recent analysis of both captive and non-captive auto finance companies, Fitch Ratings is showing even higher increases in 60-day delinquencies over the same period¹. Most significantly,

¹ "60-Day Delinquencies hit 10-year High."
http://www.chicagotribune.com/business/chicago_0215feb15_0_6658246.story. 15 Feb 2008.

charge-offs are ratcheting upward in parallel. As Figure 1 shows, Fourth Quarter 2007 charge-offs for consumer lending were 45% above the same period in 2006.

Market Forces

There are both macroeconomic and auto finance-specific factors that are putting pressure on many consumers' ability to pay and, thus, fueling the current rise in delinquencies and charge-offs. With respect to the broader economy, the Department of Labor reported that February non-farm payrolls had their largest drop since March 2003². The

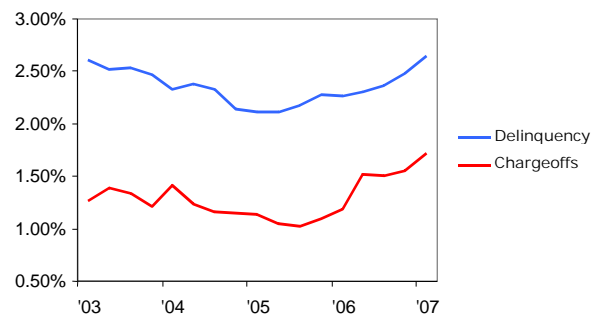


Figure 1 – Source federalreserve.gov
(excludes real estate & credit card)

unemployment rate stood at 5.0% at year-end 2007, the highest level in two years. Additionally, the Consumer Price Index continues to rise concurrently with significant slowdown in construction and fall in housing values. When looking at the auto finance market through our

² Mantell, Ruth. "U.S. Weekly Initial Jobless Claims Rise to 378,000." MarketWatch. 20 Mar. 2008.

benchmarking, survey and consulting work with the Consumer Banking Association (CBA), the National Automotive Finance Association (NAF), and the International Automotive Remarketers Alliance (IARA), we see aggravating factors are at work. As discussed in our recent whitepaper, "The Impact of Longer Term Maturities", several trends are adversely impacting auto financing losses:

- **Extended Terms.** Nearly 60% of new vehicle loans now have a term greater than 60 months. Increasingly, lenders are providing 72 and 84-month terms on vehicle loans. Some industry analysts expect the average contract term may reach 70 months by 2010. For a \$25,000 loan with a 10% interest rate and 72-month term, repossession after 24 payments will generate a loss \$1,800 higher than that of the same contract with a 60-month term. Considering that the current average loss per repossession is approximately \$5,500, an increase of \$1,800 would equate to a per-unit loss increase of nearly 33%.

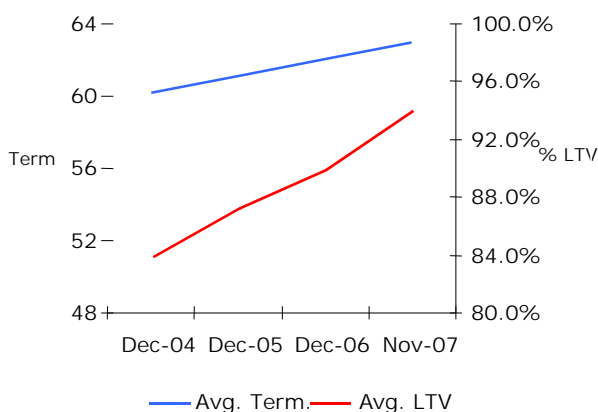


Figure 2 – Source federalreserve.gov

- **Increasing Loan to Values.** According to the 2007 CBA Auto Finance Study, average LTV's have risen to 99% of invoice for new cars and 102% of wholesale book value for used vehicles. Figure 2 shows similar

rising LTV and term patterns as reported by the Federal Reserve.

- **Declining Credit Quality.** Both the 2007 CBA and NAF surveys showed that credit quality, measured by average origination FICO score, has been declining over recent years.
- **Increased Negative Equity.** More than one quarter of loan transactions have some level of negative equity today, with an average new-car-loan negative equity of \$4,250. As a result, negotiating power in a default scenario is greatly reduced, increasing the chance the customer walks away from the loan.

The impact of these conditions on repossession rates is dramatic. Figure 3, from CNW Marketing Research Inc., shows the rise in both the total number of repossessed units and the repossession rate as a percentage of contracts: an eight percent year-over-year growth in units with 120,000 additional cars repossessed. Anecdotally, we have heard that the fastest growing regions for repossession activity are in California, Florida and the Northeast – paralleling, in some ways, the current housing market problems.

Repossession of course is the ultimate collection "remedy". However, that solution will almost always result in a credit loss for the finance source. In times of good portfolio performance, the level of such losses is usually acceptable given total portfolio return. In a deteriorating credit environment, however, more frequent use of repossession as a remedy may aggravate the higher-loss situation. While repossession is an important loss mitigation tactic in the current environment of extended terms, higher LTV's, and a weakening economy, repossession is becoming an increasingly more costly solution. Under any scenario, a 33% higher average loss per repossession cannot be tolerated for very long by any finance source. Increased internal workload further increases costs, and can further increase losses unless it is managed well.

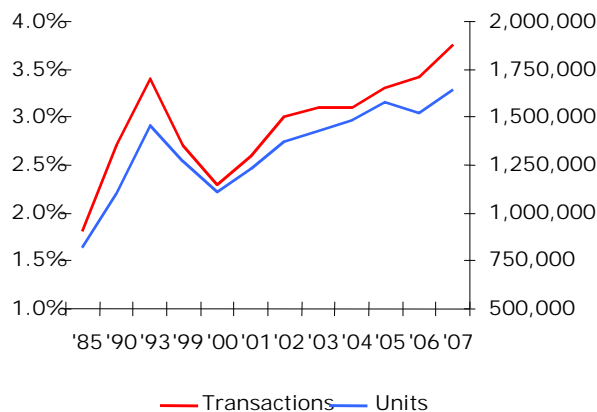


Figure 3 – CNW Marketing Research Inc.

Multi-faceted Strategic Response

The rising repossession tide is putting the spotlight on default management executives as they work to stem the rise of delinquencies that can eventually lead to repossession. The majority of over-60-day delinquent accounts result in repossession for most auto finance sources. Three strategic loss management approaches can be used to help auto finance sources ride out the storm.

Strategy #1 – Minimize Repossessions

Before making the decision to repossess, finance sources should make every effort to avoid it. This necessitates having policies and procedures, as well as trained and empowered collectors, on the front line working with delinquent customers. Effective collectors are now seen more as credit counselors than finance source employees. Considering the negative equity and extended term environment, finance sources are almost always wiser to keep the customer in the car and continue to collect payments. Of course, the customer's ability and willingness to pay are key to deciding whether to use one of the many loss prevention tactics that are alternatives to repossession. Below are several of the more aggressive remedies that should be considered in more severe economic times.

- Multiple Month Payment Deferrals
- Contract Rewrites
- Interest Rate Reductions
- Interest Deferrals

Deferrals have long been part of the tactical tools available to loss prevention specialists. We are now seeing liberalization of the deferral criteria to more than the one or two total deferrals over the life of the loan that has traditionally been the norm. Another emerging trend is the systemic identification of candidates for the rewrite option. This group of candidates can be organized as a dialer campaign and assigned to a dedicated group of specially trained loss prevention specialists to work the cases. If the customer is agreeable and qualifies, the rewrite package can be completed and closed through the mail.

Strategy #2 – Effective Remarketing

If, after aggressive pursuit of alternative loss prevention tactics, repossession is the only solution, there are more items to consider to maximize resale values. Efficient remarketing requires both channel management and process interval discipline. Good remarketers know which sales channel will yield the best returns. However, because finance sources are required to sell repossessed units in a commercially viable venue, physical auction has been the predominant sales channel. Increased repossession resale activity can thus drive auction returns lower, further increasing losses.

As repossessions increase, so, of course, do carrying costs. For a typical \$10,000-valued unit, carrying cost, storage cost and depreciation can reach \$1,000/unit, in addition to the significant transportation, reconditioning and auction costs incurred to dispose of these units. According to the 2007 IARA Automotive Survey, repossessed units are harder to sell, take longer to sell, and hold their value less than normal end-of-term units. This, together with the expense of carrying repossessed inventory, makes efficient remarketing a high priority.

In the current repossession environment, allocating adequate resources to remarketing and paying close attention to process metrics can help avoid the consequences of swelling inventories.

Strategy #3 – Aggressive Recovery

Finance sources earn reputations in the marketplace for their policies and actions: “good customer service”, “liberal purchase policy”, “easy to work with”, “quick to repossess”, and so forth. One important reputation that has a material effect on losses is the reputation for pursuit of deficiency balances. Aggressive pursuit of deficiencies is essential to both minimizing repossessions and minimizing net losses. A finance source that is viewed in the marketplace as soft on deficiency recovery will have more delinquent customers agree to (or even suggest) turning in their vehicles. Conversely, knowing any deficiency balance will be pursued aggressively for collection will motivate customers to seek and agree to solutions other than repossession. Finally, of course, effective recovery operations collect more and reduce overall net losses.

Repossession High-Water Checklist

Here are some areas that should be top of mind for loss prevention executives:

- Strategy – Focus on alternatives to repossession and simultaneously prepare for more repossessions.
- Policy and Procedures – Ensure alternative remedies are available, understood, and used as aggressively as warranted.

- Human Capital – Ensure adequate competency and high-tide capacity in the collections, remarketing, and recovery operations.
- Technology – Upgrade MIS where necessary and employ creative collection, remarketing, and recovery dialer strategies and campaigns.
- Alignment – Ensure timely, ongoing feedback between Loss Management and Credit Underwriting departments.
- Vendor Management – Ensure appropriate performance metrics and incentives are in place for repossession 3rd parties.

Going Forward

We have not yet reached the bottom of the current economic cycle that is impacting customers’ ability, and in some cases, willingness to pay. Auto finance executives must continue to review and optimize their loss prevention tactics to ensure they are using those that provide the most economic benefit, and that the processes supporting them are as efficient as possible.

There are options for managing risks from rising repossessions – and every finance source’s successful solution will vary based upon its unique needs and business model. The institutions that conduct a thorough self-examination and use internal tools and business intelligence effectively will be the most successful at mitigating repossession risks. We have all seen challenging market cycles in the past. When the flood subsides, high-performing finance sources will emerge with even more effective loss management strategies, processes, and teams.

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