Joel Kennedy: Guidance for breaking through lending barriers

JOEL KENNEDY

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SAN DIEGO — Recently, TruDecision chief executive officer Daniel Parry gave a presentation to the California Financial Services Association (CFSA) annual meeting in San Diego titled, “Breaking Through Lending Barriers.” The presentation focused on the evolutionary process that banks, captives, finance companies and dealers that hold their own contracts tend to go through in order to level up.

Following the presentation, both Daniel and I were pulled aside by a number of attendees who really picked up what Daniel was laying down. While both Daniel and I have written many articles and given many presentations, I have never had so many people provide the same feedback. “It was like you were talking directly to me and my situation.”

We were obviously pleased that the message resonated so well with the group, so I want to get the message out more broadly in hopes that this may help even more operators.

The defining characteristics of growth

For the most part, companies operating in the preliminary phases of business development lack sophistication in a relative sense. And, this makes sense, because the most important thing for early stage companies is to accumulate several (say two to five years) worth of performance data to demonstrate the viability of their model, so they can get a debt deal and lever the business.

Operating at a net loss during this period is often by design as substantial capital investments need to be made simultaneously in order to simply stand the operations up. At this stage, it is all about demonstrating that with the addition of leverage and some growth that the business can generate profits thanks to economies of scale.

As companies move through the levels of maturity, more sophistication and complexity is layered on. Operating the business “by the gut” gives way to managing by the numbers using operating reports that are initiated manually, and (in most cases) eventually migrated to automated reports possibly even generated out of analytical (not operational) data stores.

At the same time, strategic support departments are staffed up (think IT, HR, risk) opening the door to more sophistication and growing pains. Think about the CEO who is used to walking over to the business analyst and getting service, now being told that they must submit a trouble ticket and get in queue with the rest of the business’ requests in order to get satisfaction. The business is seeing that the old ways of doing things are tough to change.

From this point, an interesting thing happens for most businesses. They start looking outside to benchmark and they are very interested in what their peers are doing with hopes of making changes that ultimately moves the needle with respect to profitability. This mindset and the exercise of benchmarking is actually a very solid strategy that I endorse, however, there are some pitfalls. None of your competitors are like you. You all have different credit and collections programs, operations cost, size, and loan performance. The CEO's eyes are opening up, and they are seeing barriers.

Common barriers to successful growth

The barriers to successful growth are anything that limit your ability to secure cheaper cost of funds, improve the quality of your decision making, improve your control over the business results, improve loan performance, and improve efficiencies.

Some of the popular strategies that are commonly used simply don't address these barriers, and the common ones are:

— Competing with the big boys sounded like fun: Take for example a small finance company that is starting out with one local field rep, a credit analyst and no systems (i.e. no app portal, no loan origination system). This is an organization that is tough to scale and grow with any economies. So, the business engages the systems necessary to decision applications faster, resulting in more "head-to-head" competing for contracts with larger participants.

Unfortunately, competing with the big boys means that you are paying a lot more for apps and associated services (credit bureaus, fraud solutions) and not seeing any changes in credit quality or funding volumes. It isn't long into this stage when the CFO points out that you have a very low book-to-look, and your costs per funded contract have skyrocketed because of it. You thought you were breaking the mold of your old ways of business and really competing, but you are really paying to look at loans that your competitors will ultimately capture, and you are booking the same contracts and quality as before.

The fact is that banks, captives, finance companies and dealers get different bottom-line performance from the same originations. Finance companies don't have the same expense structure as banks and captives, yet they compete head-tohead with these entities. Finance companies, therefore, have to consider what that means to competing with respect to deal structure (such as rate, LTV and term) and how they think about yield, discount, expenses and losses.

— Mind the analytical gap: Take two different loan packages and hand them to an underwriter and ask them this question: If you were only able to fund one of these contracts, which one would it be, and why? Good underwriters will provide you with a sound response. Have them to structure both deals for capture, and ask them a second question: Estimate the losses on each of these two loans. Crickets…

In order to make the leap to the next level, lenders must have reliable loss estimates on a per-loan basis. Doing this correctly requires lenders to zero in on their historical loan performance and loss timing to come up with estimates that are calibrated to the lender. One size does not fit all!

In order to short-wire the process of building up a custom, calibrated scorecard that estimates likelihood of loss on a per-loan basis, many lenders perform a rudimentary analysis of their historical loan portfolio and come up with a new set of credit rules. e problem with this approach is that it tends to be so broad-brush that it results in lenders passing on profitable contracts and closing fewer of the higher quality contracts.

Over, around and through: Breaking the barriers

While the barriers are there, they are not insurmountable. And yet, we still see ourselves making the mistake of expecting different results from applying the same approach. By laying out the barriers, and thinking about ways to overcome them, we can ensure that the automotive lending market matures in the most efficient way through this upcoming credit cycle (i.e. downturn?).

Some thoughts on how to think about growing over, around, and through these barriers:

— Application costs and effciencies: Tightly manage the dealer and application pipeline. Inefficient app submissions that are “shot-gunned” in from the dealer indicate that you haven’t really educated the dealer about your lending box. Getting apps that fit your buying box and have a high likelihood of capture is what you are looking for. Be maniacal about setting expectations around this with your dealers and sales force. Routine culling of dealers that submit a lot of apps and fund few-to-none is a quick-hit way to improve your book-to-look percentage.

An even better solution would be to incent your sales force and dealers to deliver efficient fundings and layer on loan performance (this measure obviously takes a while to be fully baked).

—S top flying blind when it comes to credit: Lenders that had no analytic credit decisioning in place feel like they are flying blind — they have no way of knowing the impact to default risk on each deal, or what changing the loan structure will do to improve their position. An evaluation of that lender’s historical loan performance often provides the first look at the risk within their existing portfolio. From that point, an examination of the lender’s loan program and loan tiers to identify opportunities to avoid unnecessary risks while exposing opportunities to get more aggressive on higher quality deals — and to more easily discern the difference in these deals using data and science.

Smaller, less sophisticated lenders will see significant benefits from comparing their program against larger non-prime data sets - that will provide a more reliable answer on a per-deal basis. e results will be yields and losses that are better aligned with estimates, and the lender can make this happen while not reducing capture rates.

Lenders that already have analytic credit decisioning in place may have a scorecard that is out of date, built on attributes that are subject to changes in the market, or simply requires too much in terms of cost and resources to manage. Just as with the lender that had no prior analytic credit decisioning in place, the lender can evaluate their portfolio, loan program and isolate areas of opportunity. They experience the same bottom line benefits of improved loan quality, improved yields and closure rates.

Additionally, the removal of expense from the business and more efficiently underwritten loans will reduce the cost per loan, streamline operations, and reduce variation.

Let’s go team

I have always considered myself to be as patriotic as the next guy, but I never felt more patriotic than when I had more than 100 people working for me at the lending business that I founded. What Daniel and I saw at the CFSA Conference was the power of the conviction and the entrepreneurial spirit. You can’t help but be touched by such special people going out there and fighting to make automotive lending a winner.

is is the reason why Daniel and I go to work every day, why we go to conferences and talk or moderate panels, write articles and participate in trade associations. We want to see the ecosystem grow and thrive.

Joel Kennedy is chief operating officer of TruDecision. As president of the National Automotive Finance Association, Joel is passionate about growing and improving auto finance ecosystem. Joel has over 24 years' experience helping big banks down to startup finance companies to build, grow, improve, and repeat. He can be reached at (240) 3082169 or joel.kennedy@trudecision.com.