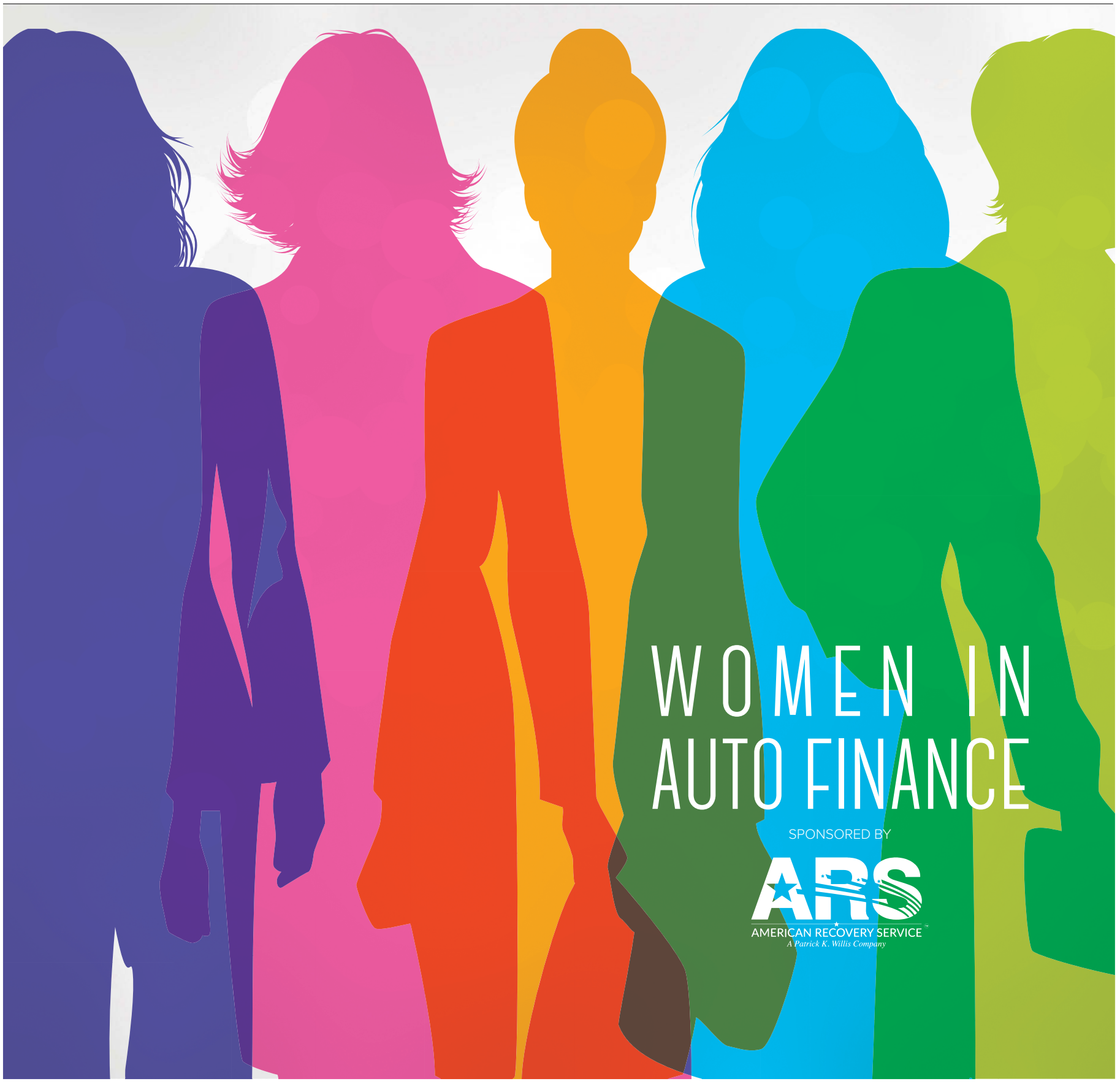
AFJ

Auto Fin Journal

Business Intelligence for Automotive and Auto Fintech Executives

September + October 2019 // Vol 2, No 5

autofinjournal.com



Preparing your operations for recession

There are a number of indicators that you can look at, that while not predictive alone or even bundled together, are worth keeping an eye on.

JOEL KENNEDY

SAN DIEGO — Talk of a recession has been going on for the better part of this year, but the squawking has definitely increased. It feels a lot like when you have to go to the dentist for a root canal. You know what's coming, and it's going to stink, and you are scared.

But you take a deep breath and step forward into what you know you have to do and figure "why delay the inevitable." It really seems that investors and financial markets have reached capitulation in their minds and just want this darn recession to hit (after all, it IS inevitable, right?) so we can all just get it over with and move on. While this thinking makes sense for confronting a root canal, I have to scratch my head at why we would apply this logic to our economy.

Recession is defined as two consecutive quarters with declines in trade and industrial activity. Recessions normally have a duration of six to 16 months, while the Great Recession lasted 18 months. The biggest hits tend to come in manufacturing, luxury and retail industries. Jobs in financial services obviously take a hit as a direct consequence. Which leads us to the conversation that we all need to be having: What do I need to do to best prepare my business for a recession?

A brief look at the macro environment

There are many, many, many measures that people use to predict a recession. The ability to time the recession is darn near impossible, especially when you consider that economists have a tough time saying that we are in a recession when we are actually in the midst of one. So, let's just agree that recessions are best called in the rear-view mirror. With that said, there are a number of indicators that you can look at, that while not predictive alone or even bundled together, are worth keeping an eye on:

— Inverted/flattened yield curve: While many look at the inversion of the 3-month versus the 1-year yields, the 2-year to 10-year yield curve compares two grander time frames that gets a lot more notice, and this particular yield curve recently inverted for the first time since the Great Recession.

— Low unemployment: Hold on a second, low unemployment is good, right? Yeah. But when that trend changes (and changes drastically) it is a critical domino that fuels the recessionary fire.

— Stocks correcting: Again, to my point above, it really feels like the American people and even President Trump are behaving irrationally, or dare I say emotionally? While most of the market's dumps are legitimate reactions to real data (such as unemployment, manufacturing, etc.), the overall sentiment feels really shaky. No love here!

— Monetary policy: Ahh, monetary policy. Could this be the last domino to fall? Well, not on President Trump's watch! Openly questioning if Fed Chairman Powell is a bigger enemy to the U.S. than Chairman Xi of China must be Trump's idea of bullying the Fed into holding the line on one of the last defenses standing in the way of a recession.

While it seems everyone is resigned to the fact that a recession is inevitable (which it is not), nobody really knows exactly when this recession will hit. Best guess? According to the NY Fed's latest guess, we should be looking at mid-2020.

I'll have the usual

The traditional response to a recession by lenders, and finance partners has been:

— Scrutinize loan quality: Reports of rising delinquencies (particularly in the 60+ days past due bucket) have been out for a few months. In response to this, lenders tend to tighten credit standards, and for most this also equates to lower originations, resulting in a shrinking portfolio due to fewer new loans replenishing the run-off. The CFO is forced to increase the allowance for loan losses, which while necessary, only makes matters worse.

— Secure financing to weather the cycle: In an ideal world, lenders' would have debt agreements and terms in place that are longer than the duration of any recession. However, if you are up for a renewal, and your portfolio is already showing signs of stress, getting that next deal can be tough. Even worse, the debt provider can raise the equity requirements forcing a cash event, or yet even worse than that, the lender starts tripping loan triggers and breaks covenants, resulting in the line being yanked.

— Cut costs: When originations decline due to the tightening of credit standards, financial managers see their health ratios start to dump, so they "right size" their organizations through reduction in force, elimination of "non-essential" services, and looking for every opportunity to cut costs. Cutting dealers is always a favored way to eliminate the cost of inefficiency in a low book-to-look environment (generally the case in non-prime, indirect). Unfortunately, many services that help control the roll of delinquent accounts are dropped and operations becomes desperate and tries to double-down on internal efforts that don't work.

What smart consumers and lenders are doing to prepare for recession

Here is my assessment of what the smart consumers are doing.

Lower-to-middle class workers didn't bounce back (in terms of recovery of prior pay rates) as well for the last two recessions. Smart consumers will know this and set up some protections knowing that the other side of a recession may come with some additional debt piled up that won't be helped by higher wages. So, let's think about what smart consumers will do to protect themselves.

Now, we all know that not all consumers that have loans will behave this way, however these can be some points of caution for operators to get ahead of with consumers to proactively help them:

— Save cash: Employer benefits offering more options here like pay advances and enabling customers to make purchases and have them satisfied over time (with no interest) via payroll deductions can be helpful in preparing and building discipline. Ultimately though, consumers need to be prepared for joblessness, which means 6-12 months' worth of savings to cover joblessness (assume the length of the recession). Knowing that most American consumers don't have enough saved to cover a one-time hit, this is a real problem. What will lenders do when customers don't have a job and are not eligible for an extension?

— Purchase warranty/service contract: Warranties/service contracts can remove a lot of stress from borrowers that don't have the cash on hand to deal with a major mechanical issue. At my last automotive finance company I observed that contracts (loans) with a service contract charged off at 50% the rate of those without one. Additionally, since we managed our own service contract loss pool, we were in a position to approve repairs that were outside of the scope of coverage. This really gives operators a "way to go" to help customers.

— Consider more flexible, open-loan terms: Flexibility introduced by leases, and the fact that warranty and gap can be wrapped into the monthly payment provides additional down-side protection to both borrowers and lenders. There sure seem to be more leasing options for non-prime borrowers than ever before. In fact, I recently met a lease originator that books leases on behalf of a variety of lenders and they guarantee the residuals for the acquiring lender. This down-side coverage to the lender benefits both lender and borrower.

— Slash luxury expenses: Just prior to the Great Recession, gas prices were peaking over $4 per gallon. Large SUVs and other vanity/highline vehicles ended up being surrendered, only to get slaughtered at auction. The net result is that lenders took huge hits. Some basic

planning on what types of collateral tend to hold up during recessionary periods can help both borrowers (higher quality, higher mileage) and lenders (better recovery values) alike.

Here is my assessment of what the smart lenders are doing.

If I could isolate one big thing that differentiates smart lenders that will succeed from those that will struggle it is: being real with yourself. If you know that a recession is coming and there are preparatory activities that can help you weather the storm, why do many of us simply stick our heads in the ground and pretend that it isn't happening? Whether it is management hubris or just plain status-quo laziness, there really is no excuse for not being prepared! I pose a number of questions for lenders to ask themselves in assessing their readiness.

— Understanding risk/exposure in your portfolio: Have you relaxed credit standards? Have you relaxed credit standards and grown your portfolio as a result? What have you done to improve loan quality for the prior 24-month period? What about the collateral in your portfolio, how are auction values for these vehicles impacted by a recession? Are your best customers being sold out from under you (either called back into the dealer, or refinancing)?

— Plan for unemployment and non-performance related to that: Do you have specific plans to engage borrowers and keep them in their cars during a time of recession? Do you have a good handle on the reasons for repossession, and a planned path of resolution for each one? When was the last time you reviewed your deferment policy and practices? Do you have a good way to discern who should qualify for an extension based on data and fact?

— Collections practices: Have you made improvements to your collections and risk mitigations processes? Have you kept your business up to speed with the times (talk, text, chat, email, convenient payment options)? Have you analyzed what underlying factors indicate a propensity to roll? Do you have a plan to address these particular populations that may have indicators that are beyond/unique to max balance and days past due?

Don't Have the Usual! Be like George Costanza

In the 1990s TV show "Seinfeld," George Costanza goes through a soul searching exercise in which he realizes that every one of his instincts is wrong and the result is his miserable life. George decides that he will do the opposite of his instincts in hopes that it will change his fortunes.

The shrewdest investors know that you buy the blood when the market is dumping — they always keep some cash ready to enter the market on the dip. While everyone else is evacuating their houses and heading for their bomb shelters, these contrarians are doubling down on discount pricing knowing that the market will ultimately bounce back. For the most part, the biggest enemy to a good investor is their emotions. Emotional investors cash out and lose value by dumping at market lows, but more importantly they surrender a strategic position with which to benefit from the positive side of a correction.

The same holds true for lenders operating in a down cycle. We need to be looking at the opportunity of growing during the down cycle. And how we do that and win is by growing while capturing improved loan quality and increasing efficiencies during a time when those who are scaling back and recoiling are helping to create an environment where the strong can thrive from lower levels of competition.

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 more than 24 years' experience helping big banks down to start-up finance companies to build, grow, improve, and repeat.
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