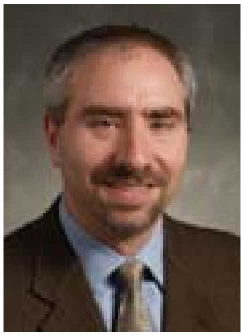
Banking
IN THE NINTH
DECEMBER 2014

NINTH DISTRICT HIGHLIGHTS

The State Member Bank Charter: Its Current Supervision



Ron Feldman

End-of-year performance reviews bring both dread and useful reflection. The latter motivates this note. I decided to consider the state of the state member bank charter and its supervision, both because of the time of the year and because of an anniversary of sorts; I have had the honor of leading the Minneapolis Fed's Supervision, Regulation and Credit (SRC) department for about five years.

I conclude that the charter is strong and that the supervision of state member banks (SMBs) is effective and efficient. The keys to this positive assessment are:

1. **Our local perspective.**
2. **A robust "relationship" program with state member banks.**
3. **A professional staff who work with banks to prevent problems from growing.**
4. **The strong commitment to improve our efforts.**
5. **A charter with structural benefits.**

I discuss these points in more detail below. As always, please contact me at Ron.Feldman@mpls.frb.org if you have any questions or comments on this article.

1. Our local approach

The Federal Reserve System has regional Reserve Banks to ensure that the voices of "Main Street" are important inputs into our work. Our supervision rests on local focus, which makes the supervision effective. It all starts with the state charter, allowing us to partner with state banking departments. Both supervisors look to local economic and banking conditions when making assessments rather than following a one-size-fits-all implementation. Facilitating that approach are our local offices in Minnesota and Montana, which house the leadership of our supervisory efforts, and staff who come from virtually all corners of the Ninth Federal Reserve District.

2. Robust Relationship Manager and Consumer Affairs Contact programs

Our relationship program is a key to our effective supervision. We described these programs in our *"Role of Relationship Staff in Banking Supervision"* article so I will be brief in summarizing the benefits of these programs. In short, they allow us to

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CONSUMER COMPLIANCE & SAFETY & SOUNDNESS UPDATE

Indirect Lending

By Timothy Melrose, Senior Examiner
Karin Bearss, Vice President

The number of community banks engaged in so-called indirect lending has increased, in part driven by banks' efforts to increase earnings. In these banks, indirect lending involves a bank funding consumer purchases of personal goods such as autos, boats, recreational vehicles (RV) and motorcycles through a third party, typically the retailer selling the goods. Indirect lending raises unique safety and soundness and consumer compliance risks. This article identifies steps banks should take to manage the risks of indirect lending.

We begin by distinguishing indirect lending from direct lending and identifying the risks unique to indirect lending. We then discuss supervisory expectations for risk management of indirect lending in the following areas:

1. Dealer management
2. Consumer contract underwriting
3. Consumer compliance
4. Management oversight

Direct versus indirect lending

Banks participate in consumer lending by making direct loans to their customers. Banks can also establish a relationship with a third party, such as an auto or RV dealer. The first type of activity, direct lending, has traditional credit and consumer risks associated with any consumer loan. The second type of lending, indirect lending,

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2014 Risk List

Banking in the Ninth articles published in March 2012 and September 2013 discussed the Federal Reserve Bank of Minneapolis' semiannual process for identifying high or emerging risks facing Ninth District financial institutions. Our list in 2012 focused on credit risks, while the list in 2013 focused on earnings and actions banks are taking to address weaker-than-expected earnings. The most recent list, completed in June and relying on data as of December 31, 2013, identifies Strategic Risk and Cyber Security as the two most significant risks facing Ninth District institutions. You can find the full list, including our supervisory responses to identified risks, online at minneapolisfed.org/publications_papers/pub_display.cfm?id=5431.

Have we captured the risks your bank is facing? Are there other actions we should take to ensure that banks are appropriately managing these risks? Let us know what you think by emailing us at mpls.src.outreach@mpls.frb.org.

NINTH DISTRICT HIGHLIGHTS *continued from page 1*

a. Make staff who are knowledgeable about individual institutions available to assist and support SMBs and bank holding companies (BHCs).
b. Coordinate Fed communication to the banks—reducing multiple contacts from multiple people where possible.
c. Provide continuity in supervision.
d. Offer the regional focus discussed above.
e. Support our proactive and supportive approach to our supervised institutions.

> The effectiveness of bank supervision comes down to the quality of the individuals conducting it. Our supervision staff are highly trained and skilled and they make it their priority to provide effective feedback to state member banks.
>
> *Ron Feldman*

3. Professional staff focused on preventing problems

The effectiveness of bank supervision comes down to the quality of the individuals conducting it. Our supervision staff are highly trained and skilled, and they make it their priority to provide effective feedback to state member banks. And what is the focus of that feedback? SRC staff members focus on risk management in an effort to prevent problems from becoming serious, rather than waiting for problems to develop and then coming down hard.

4. Commitment to improvement

All of my performance reviews identify, to use the phrase, "opportunities for improvement." I hope what counts more in the long run is my commitment to take those opportunities seriously and try to improve, even if I do not always succeed. The same holds true for our supervision in general. We do not always get it right. To compensate, we seek out feedback and change based on that input. We are improving our new risk-focused consumer compliance examination program based on SMB feedback, to give one example.

5. Structural benefits of the state member bank charter

The various bank charters have strengths that work well for different banks. Some SMBs have noted the benefits of having a single supervisor for the BHC and its bank, for example. Even the fact that Federal Reserve capital stock pays a dividend, which typically received little notice previously, has been commented upon favorably given the rate environment!

2014 has been a challenging year but thanks to our staff, I think it was a year in which our supervision and the charter we supervise came out well. That said, I noted that commitment to improvement is one of our strengths. In that vein, I will discuss some recent steps we are taking to improve supervision in our next issue.

INDIRECT LENDING *continued from page 1*

creates the same risks but adds a layer of additional risks. Indirect lending typically takes one of two forms: (1) the dealer may originate loans to consumers, which the bank then purchases or (2) the dealer may forward the loan application to the bank, which then originates the loan. The risks are the same under both scenarios.

Many indirect lending risks arise because the customer interacts directly with the third party (referred to as a dealer in this article) rather than the bank. The bank, as a result, has limited control over or direct insight into the transaction. Because of this, indirect lending activity raises unique consumer lending risks, such as the following:

- Dealers unable to fulfill obligations, such as requirements to repurchase loans acquired with recourse.
- Customers providing incomplete or inaccurate personal financial information. Customers may also provide inaccurate financial information when applying for a direct loan; however, in a direct loan, the bank lender can ensure that information is complete and can ask follow-up questions when appropriate. Further, bankers tend to make direct loans to local customers, which helps the bank detect potentially inaccurate information; indirect loan borrowers tend to be more remote.
- Dealers engaging in fraudulent transactions or delaying lien perfections. Dealers may have incentives to inflate borrower income in order to ensure that the bank will purchase the loan.
- Dealers needing to comply with certain consumer protection laws and regulations as detailed in the Consumer Compliance section below.

Most importantly, bankers cannot outsource their loan underwriting or consumer compliance responsibilities to the dealers even if the banker is not engaging directly with the consumer. Loans originated through the dealer must meet safety and soundness standards and comply with all consumer protection laws and regulations to the same extent as direct loans. Accordingly, bankers need to ensure that their risk management practices provide for appropriate oversight of the indirect lending activity. We now discuss those needed risk management practices.

Risk management practices

Dealer management

Effective risk management of the dealer relationship requires well-defined bank policies and practices. In particular, the bank should require a written agreement between the bank and each dealer. The contract between the bank and the dealer should include the key provisions standard for third-party vendor contracts. Key provisions would:

- Detail performance expectations for the dealer, including consumer compliance expectations.
- Outline the bank's ability to perform on-site reviews of the dealer.
- Define requirements for the dealer to provide ongoing financial information.
- Address compensation arrangements clearly. [1]

Policies should also include clear underwriting criteria for determining which dealers the bank will authorize for its indirect lending program. Choosing the "wrong" dealer can increase the bank's risk for fraudulent loans, unperfected liens and inability of dealers to fulfill their obligations. The type of underwriting banks conduct must align with the level of recourse the bank has to the dealer for "bad" loans since the bank's risk level varies based on these different contract purchase arrangements. Contracts can be purchased in three ways:

- *Full recourse*—the dealer is required to repurchase the loan on demand from the bank throughout the life of the loan.
- *Limited recourse*—the dealer must repurchase the contract under certain limited circumstances or for a limited period of time.
- *Without recourse*—the dealer is never obligated to repurchase the loan.

The bank relies on the dealer's financial strength to provide support for the consumer loans when contracts are purchased with full or partial recourse. Therefore, a full credit review of the dealer is essential to ensure that the dealer can meet its obligations. Further, as with any loan exposure, the bank should set clear limits on the volume of contracts it will purchase from each participating dealer.

Since dealers assist borrowers in filling out loan applications and assist banks in perfecting liens, it is important for the bank to evaluate and manage the risk of the dealer's activities.

Finally, banks should develop a program of both off-site monitoring and on-site visits to dealers. Monitoring programs should outline clear performance parameters for each dealer, including items such as loan quality by dealer (percent past due, charge-offs), compliance reviews (appropriate disclosures, fair lending compliance) and lien searches to ensure timely filing of liens. Bank policies should outline circumstances under which it will terminate a dealer relationship because of poor performance with respect to key metrics.

Consumer contract underwriting

Bankers should have well-defined loan underwriting standards for consumer contracts in addition to the standards applied to the dealer discussed above. The bank must ensure that loans originated through the dealer meet the bank's underwriting criteria before origination or purchase. It is a best practice for banks to apply the same standards to indirect loans that they apply to direct loans.

[1] See SR 13-19/CA13-21 Guidance on Managing Outsourcing Risk for additional details surrounding contract and oversight expectations for vendor relationships, including dealer arrangements.

How should this work in practice? Bankers should apply the metrics they use in their own underwriting to indirect underwriting. Thus, it makes sense for all metrics banks use in underwriting loans to be clearly defined and consistently calculated by dealers. This requires that dealer contracts outline which credit metrics will be used in making credit decisions and how these metrics, such as loan-to-value, will be calculated (for example, will "add-on" products be included in the vehicle value).

Similar to direct lending, regulators expect all credit decisions on indirect loans to be properly documented regardless of who originates the loan. This includes decisions for approvals, approvals made with policy exceptions and denials. Bankers can better manage credit risk, ensure compliance with consumer regulations and provide support for model validation by thoroughly documenting all credit decisions. Banks should track policy exceptions in the program overall and by dealer as part of their oversight of the dealer arrangements.

Consumer compliance

The most significant consumer compliance risks associated with indirect lending are fair lending risks. Banks that originate indirect loans or purchase dealer contracts are usually considered creditors under the Equal Credit Opportunity Act (ECOA), which means they must ensure that these contracts comply with fair lending laws and regulations. Often, bankers will set a buy rate for a dealer contract and then permit the dealer to mark up the rate. The contract rate disclosed to the consumer is the buy rate plus the mark-up rate. The lender may then pay the dealer the difference between the buy rate and the contract rate. The primary fair lending risk with this type of arrangement is that, without proper controls, individuals with similar credit and other characteristics may receive different rates because of this discretion in pricing at the dealer level. Illegal discrimination can occur in this context if factors such as race, gender or ethnicity appear to have been used in setting the borrowers' loan rates. ECOA prohibits lenders from discriminating based on these and other factors in any aspect of the credit process, including when underwriting or pricing loans.

Lenders that rely on the dealer to underwrite the application may be held responsible for dealers that discriminate based on prohibited factors.

To manage this fair lending risk, banks should have compensating controls, including the following:

- Training dealers regarding fair lending laws and regulations.
- Establishing fair lending and other compliance expectations in dealer agreements.
- Imposing controls on dealer mark-up and compensation policies to limit the potential for discriminatory differences in loan rates.
- Considering eliminating dealer discretion related to loan rates and compensating dealers by a different method.
- Establishing clear underwriting criteria for purchased dealer loans and monitoring underwriting exceptions closely.
- Monitoring dealer pricing and underwriting actions at the dealer and indirect portfolio level to ensure that no discriminatory treatment has occurred.

The federal regulatory agencies discussed indirect lending and fair lending risks in an Outlook Live webinar in 2013: http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/2013/indirect-auto-lending.cfm

Management oversight

Management and board of director oversight of the indirect lending activity is critical to the success of the program. Banks should set risk limits for the program as a whole within their indirect lending policies in addition to setting dealer limits discussed above. The board of directors should establish clear guidelines for the level of risk it will accept in the program and should receive information needed to ensure that management does not exceed the established risk tolerance.

Concentration limits for indirect lending should be clearly identified and should be part of other risk limits management establishes for overall lending. While each bank may have its own relevant risk limits, bankers should consider establishing limits for the following:

- Indirect portfolio volume limits relative to bank capital.
- Limits for various types of loans (auto, motorcycle, RVs, boats).
- Limits for geographic location of borrowers.
- Limits for acceptable level of contracts made with exceptions to lending guidance.

In addition to dealer-specific monitoring discussed under Dealer Management, bankers should closely monitor the credit performance of the indirect loan portfolio as a whole. Management should regularly report to the board of directors on key credit performance indicators, such as past-due loans, charge-offs, volume of dealer repurchases and exceptions to policy. In addition, management should report to the board on the results of dealer credit reviews.

Summary

Indirect lending can be a profitable and successful line of business when properly managed. It is important that banks involved in indirect lending understand the credit and consumer compliance risks associated with indirect lending and establish controls to manage these risks effectively. Policies and procedures should be thorough and clearly communicated throughout the organization because the board, management, lenders, compliance officers and auditors all play key roles in ensuring proper risk controls over indirect lending.