POINT PREDICTIVE

Auto Lending Insights

Credit Unions' Share of Auto is Rising But Their Risk Profile Is Too

September 2023

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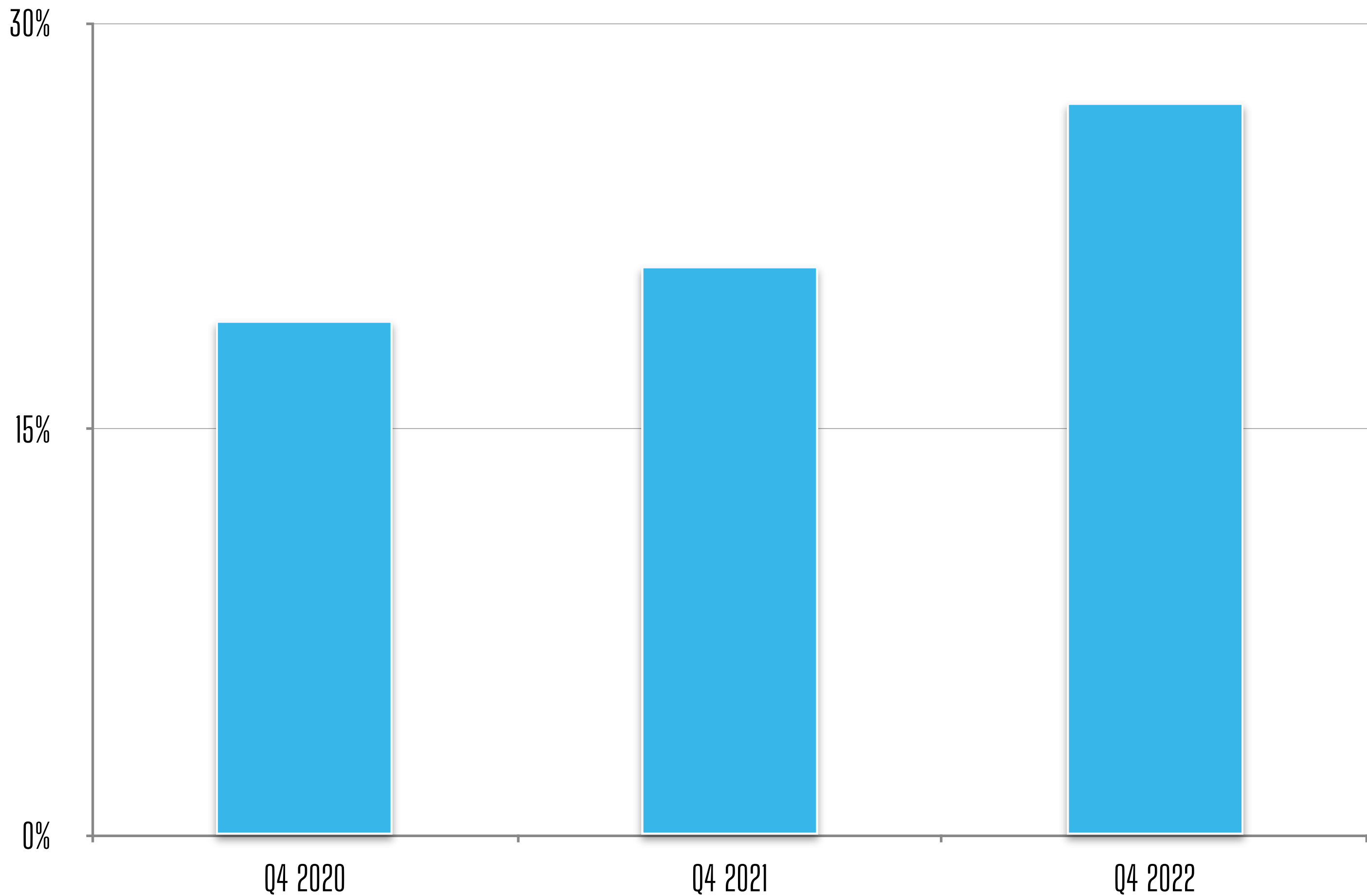
People Helping People – Credit Unions Step Up

“People helping people” is the mantra of the credit union industry, and this focus on people over profits could be a major driving force of why we’ve seen a shift in auto lending originations towards credit unions.

In Q4 2022, credit unions took over as the industry leader in originating auto loans at 27%, overtaking banks (26%) and captive lenders (24.4%).



Credit unions are unique in that they are not-for-profit businesses and are owned by their members, who act similarly to shareholders.

Historically, credit unions have largely provided deposit and checking products, also known as share accounts, to individuals who prefer not to use traditional banks. While lending to these same members has been restricted, we are starting to see a shift in this behavior, and with it comes new risks that are driving up delinquencies and defaults.

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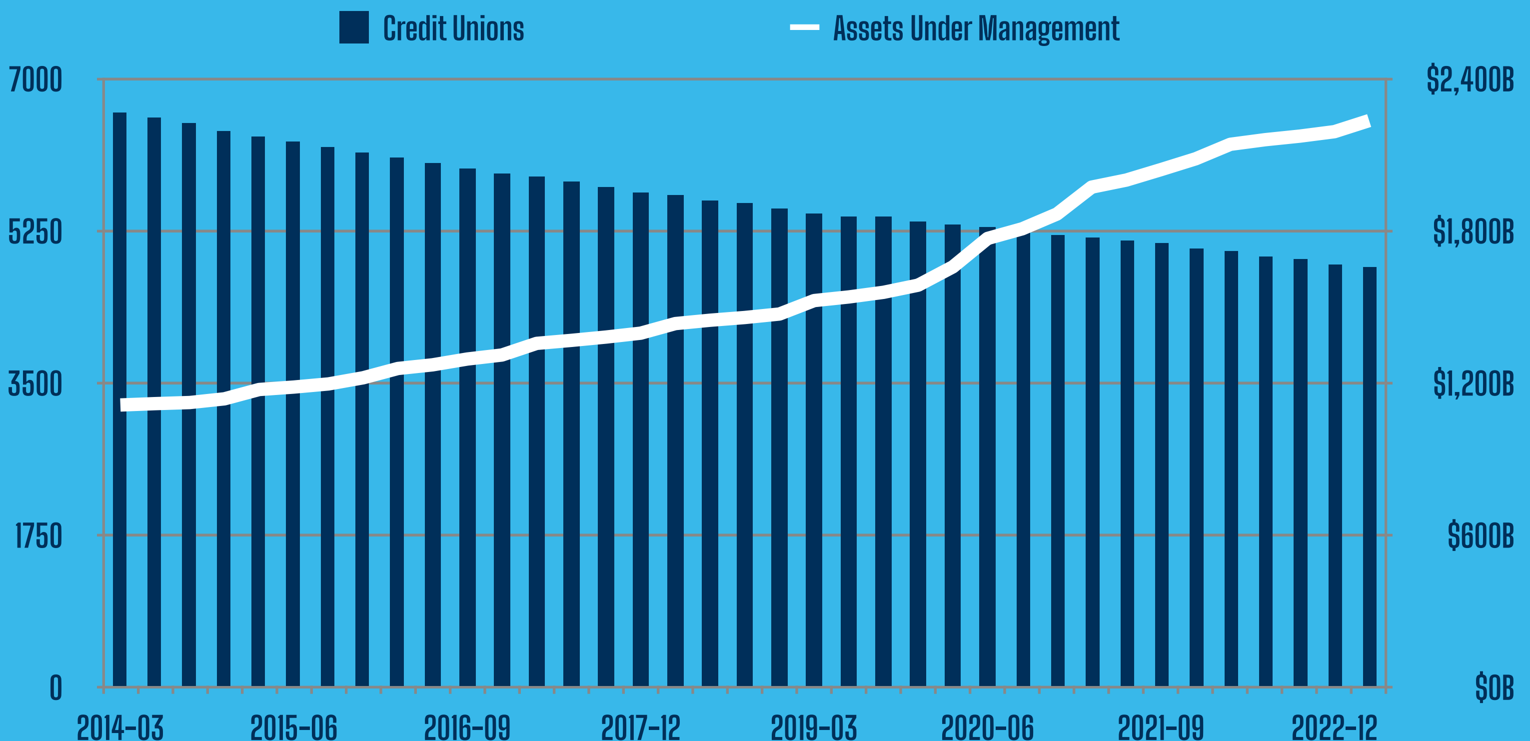
Dramatic Changes In The Last Decade Make Credit Unions A Force

Over the past decade, the credit union industry has seen a dramatic change driven by consolidation of smaller credit unions through acquisition. Since 2014, the total number of credit unions in the US has decreased by 27%, while total assets under management (AUM) has increased by more than 100%. In the same time period auto loan originations have grown more rapidly, at a rate of 142%.

Field of Membership Has Helped Credit Unions To Expand

To become a member of a specific credit union, one must fall within their “field of membership” (FOM). A credit union’s FOM is some commonality that members must share. Historically, a FOM was restricted primarily to a particular community, employer, or even religious affiliation, but recently credit unions have begun to creatively expand their FOM criteria to grow their membership, deposits, and total AUM.

Fewer Credit Unions But Those That Remain Are Growing Significantly in Auto Finance



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Credit Unions Boldly Expand Into New Auto Finance Opportunities

Credit unions took over as the main originators of auto loans by the end of 2022. While they have since dipped back below captive lenders in more recent quarters, there is an undeniable long-term trend of credit unions capturing more market share.

There are three main contributors to the increase of auto lending originations by credit unions:

1) Market Contraction Gives Credit Unions More Opportunity To Fill The Gap

Fear of a possible recession is causing many institutions, like Citizens Bank or Mechanics Bank, to reduce their footprint in auto lending, or stop auto lending completely. This creates more opportunity for credit unions to expand their portfolios because there is less competition in the market.

2) Credit Unions Are Expanding Into Subprime Lending

As they continue to expand, credit unions are starting adjust their underwriting criteria to include subprime borrowers, making credit more accessible to their members. While subprime borrowers inherently present higher risks of default to credit unions, they are able to limit these risks by leveraging insurance programs like Open Lending and the use of alternative data. Reliance on credit scores as the main deciding factor is becoming less popular now that credit unions are beginning to realize the opportunities that alternative data provides in addition to legacy credit scoring.

Market contraction, an expansion into subprime lending, and a push into indirect lending are making Credit Unions a major force in auto finance.

3) Credit Unions Are Leveraging More Indirect Lending To Expand Portfolios

Indirect lending is starting to become a preferred method of expansion for credit unions, with balances growing by more than 24% in 2022 according to CUInsights, representing the largest growth rate in indirect auto loans since 2017.

In the indirect lending world, multiple lenders will bid on an application, and credit unions can often offer better incentives, with lower rates and better service to attract new members. This represents a departure from credit unions' typical business model, where they market their credit services to existing members.

Historically, indirect lending has been a very labor intensive process for credit unions. However, Credit Union Service Organizations (CUSOs) have helped facilitate more efficient interaction between credit unions and dealerships.

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Could A Storm Be Brewing For Credit Unions?

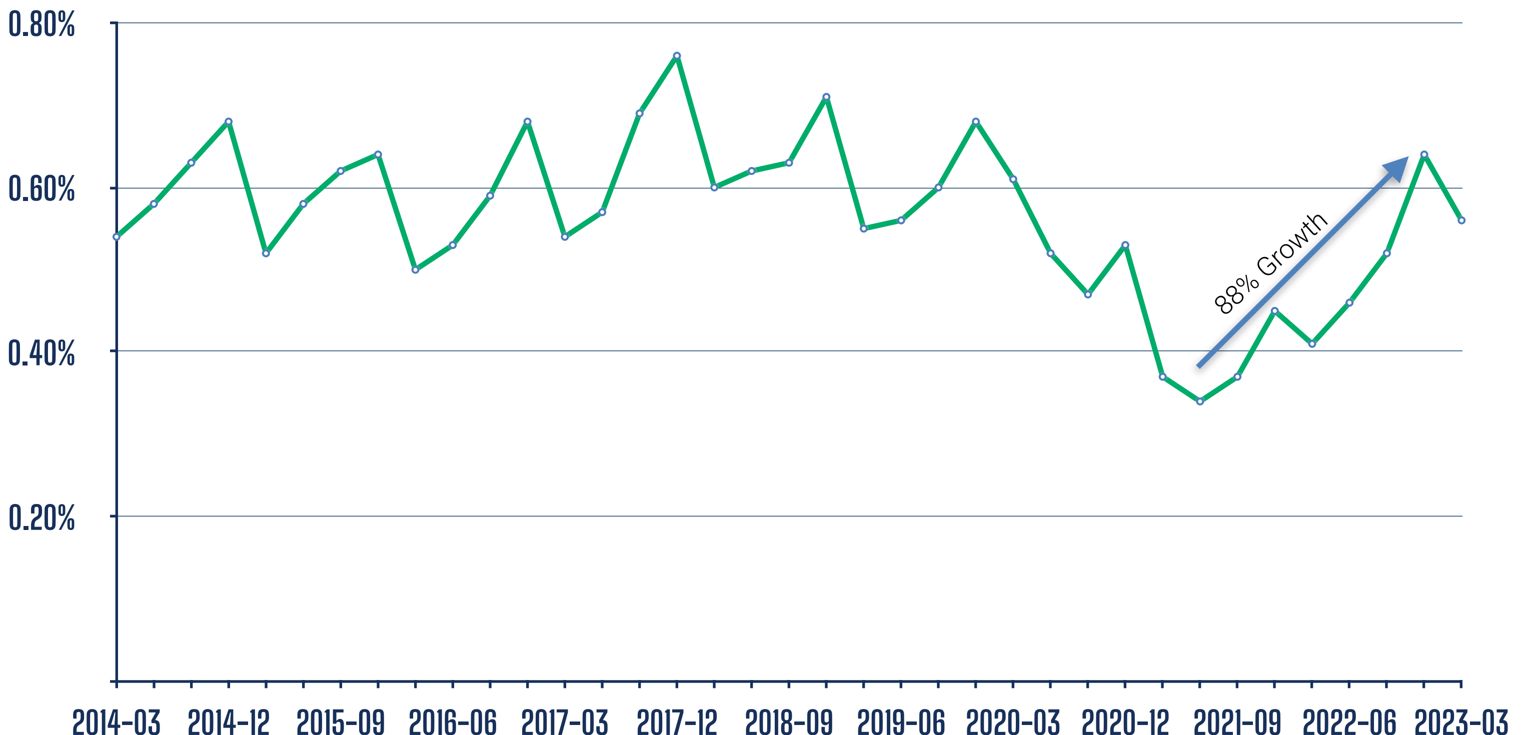
The news of credit unions' prominence in the auto lending market has made major headlines. With rapid market expansion, there are also risks of quickly taking on too much volume, or the chance that the volume being brought in doesn't perform as expected.

While analyzing quarterly call report data reported to the National Credit Union Association (NCUA) from credit unions with AUM over $1bn, we identified delinquencies and charge-offs trends that might suggest some credit unions are taking on too much risk in the pursuit of membership and AUM growth.

Since 2014, there have been peaks and valleys of 60-day auto loan delinquencies, peaking around December 2017 and bottoming out in June of 2021 at the height of the pandemic. This decrease is attributed to forgiveness programs offered by credit unions to their members which artificially drove down delinquency rates.

However, since June of 2021, we have seen an 88% increase in 60-day delinquency rates peaking at the end of 2022, which is the fastest growth in delinquency rates seen in the data.

While delinquency rates have not returned to pre-COVID highs they are quickly trending that way and could even surpass risk levels seen prior to the pandemic.



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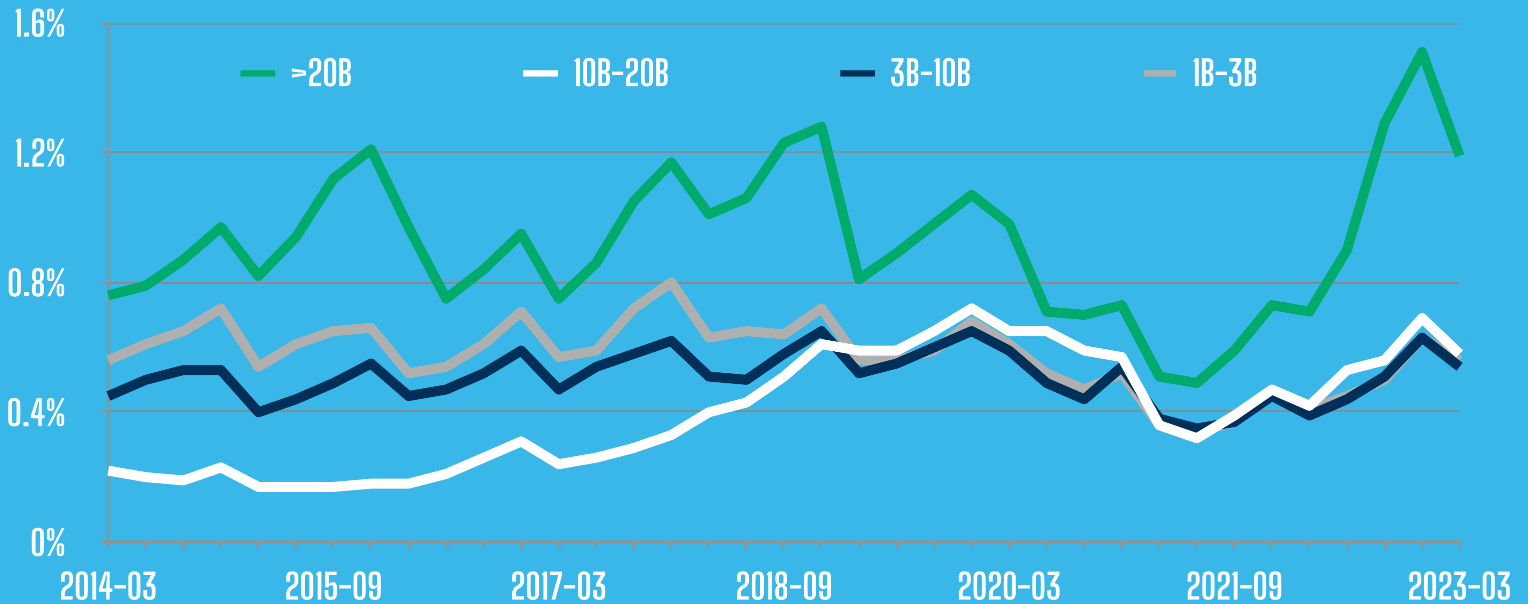
Larger Credit Unions Recent Delinquency Rates Are More Pronounced

Delinquency trends analyzed by AUM indicate the spike in delinquencies tends to be driven by the largest credit unions, suggesting that they behave more like banks than their smaller counterparts.

Those credit unions with more than $20B in AUM led the growth in delinquency rates with an increase of more than 200% between June 2021 and Dec 2022.



Each year, credit unions experience a drop in these delinquency rates, primarily driven by tax refunds being used to bring loans current. What is interesting though is that the drop from Q4 2022 to Q1 2023 was 31% less than the average decrease between 2015 to 2022.

As delinquencies are a leading indicator of overall charge-offs and losses, credit unions haven't yet fully recognized these risks. When looking at YTD charge-offs in the first quarter of 2023, we are seeing that 2023 might be a wake-up call for the credit union industry.

When reviewing the total amount charged-off in the first quarter, it is 123% more than the same time the year prior.

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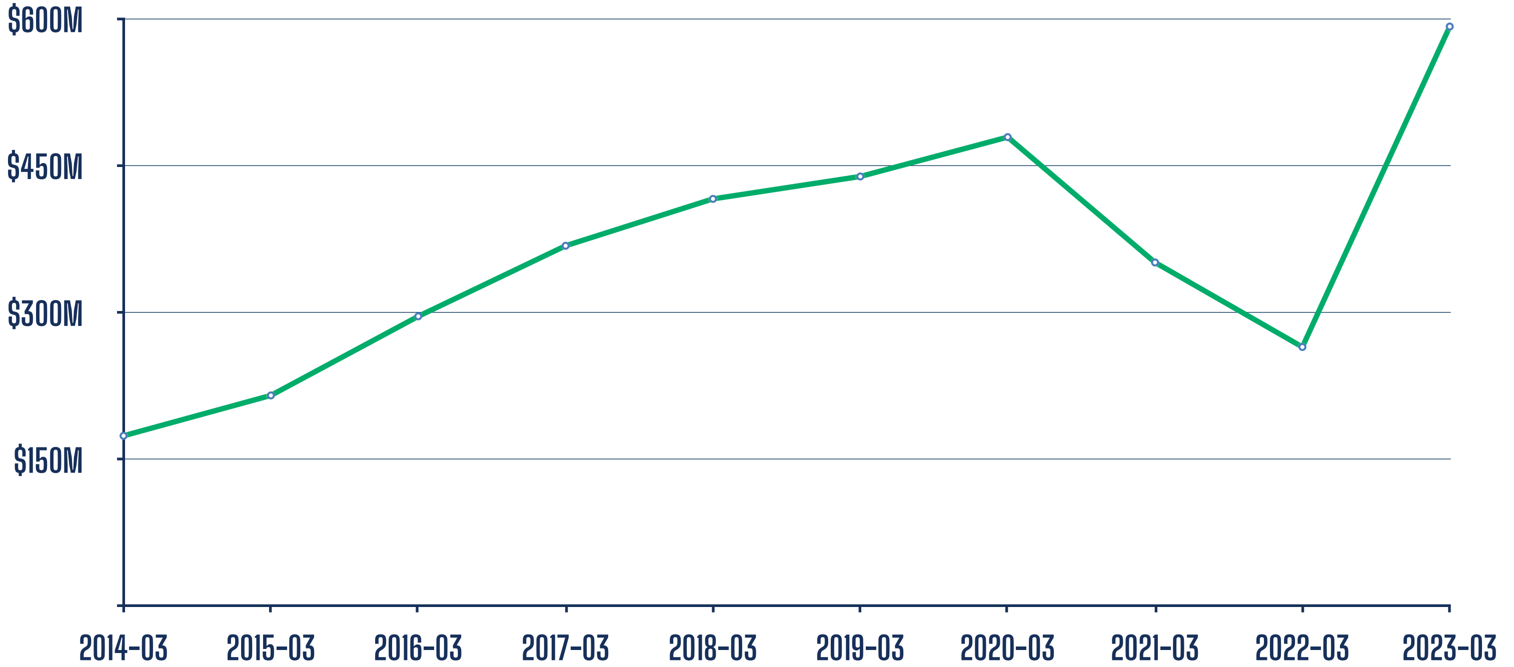
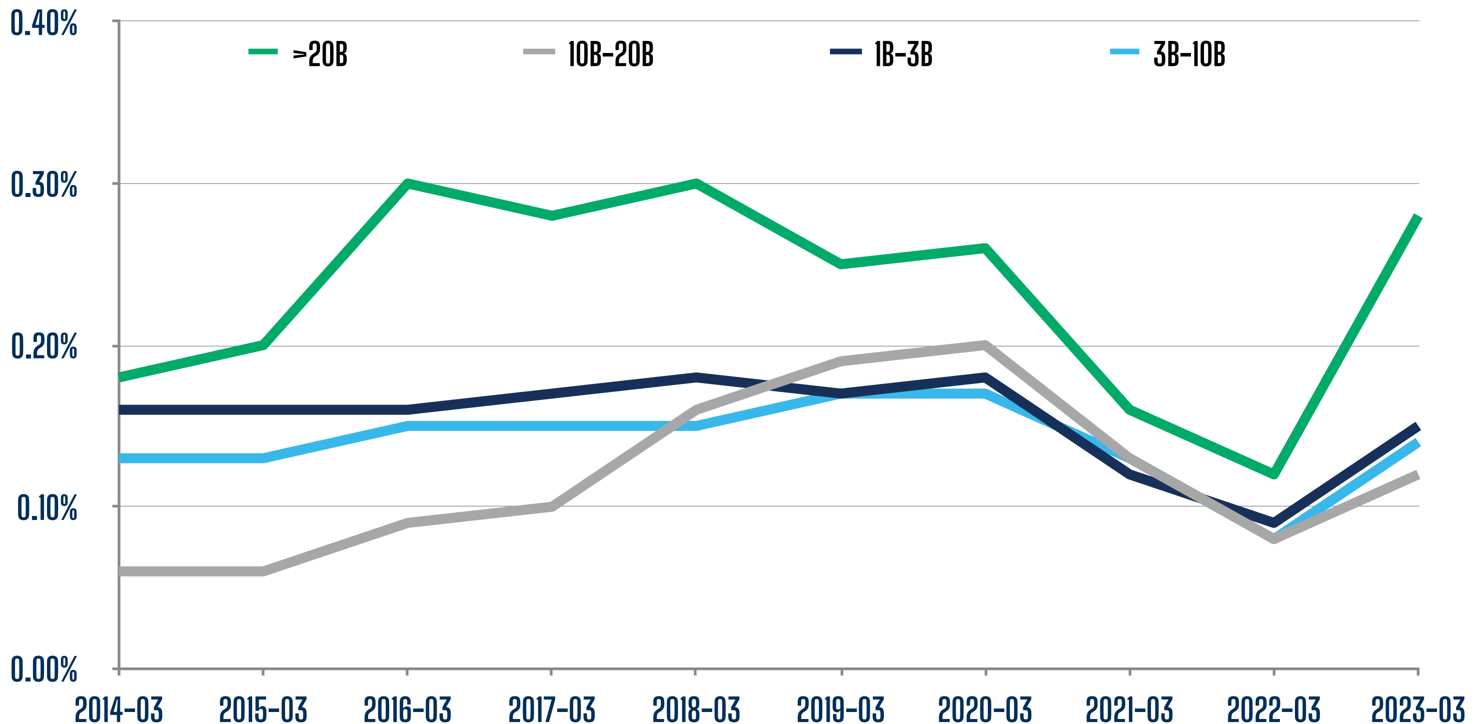


It is important to evaluate losses relative to overall outstanding balances. When looking at charge-off rates, the trend isn't as significant, but it is growing. Breaking this down by AUM group also portrays a similar story of larger credit unions possibly taking on more risk than expected, and they may realize losses this year.



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Hidden Risk May Be Driving Increased Losses At Credit Unions

There are rising risks in the credit union industry surrounding the growth in auto loan originations. Although a possible economic downturn contributes to the overall performance of loans, other factors are currently playing a more prominent role:

1) Credit Unions May Be Overeliant on Credit Scores

With a focus on member experience and a much more personal touch when it comes to banking, credit unions haven't adapted as quickly to shifts in technology as their counterparts. This includes the adoption of digital tools and the incorporation of alternative data to make more informed decisions.

While there are exceptions, the credit union industry has only recently begun to incorporate more data, scores, and solution vendors into their workflows compared to other financial institutions.

This presents more risk for credit unions for two reasons:

- **Fraud and misrepresentation take many forms**, and being able to quickly identify and stop attempts of fraud takes both knowledge and data. Whether this is incorporating fraud technology through different vendors or expanding database architecture internally, credit unions have only begun to recently adapt which opens them to more risk from fraudsters.

- **Alternative data can help identify risks outside of the typical credit score**. While it's important to leverage credit data to make informed decisions, in many cases the credit score gives only a narrow view into the behavior of the member and their likelihood of repaying, particularly for the underbanked.[1] This includes their income profile, employment, and previous application history. A member who may look good on paper may have no intent to repay.

Relying on credit scores and traditional bureau data means that credit unions may not have insight into fraud or unique risk profiles of the underbanked population

[1] The purpose of a credit score is precisely to assess the likelihood of default, however credit scores can be much more limited in underbanked populations.

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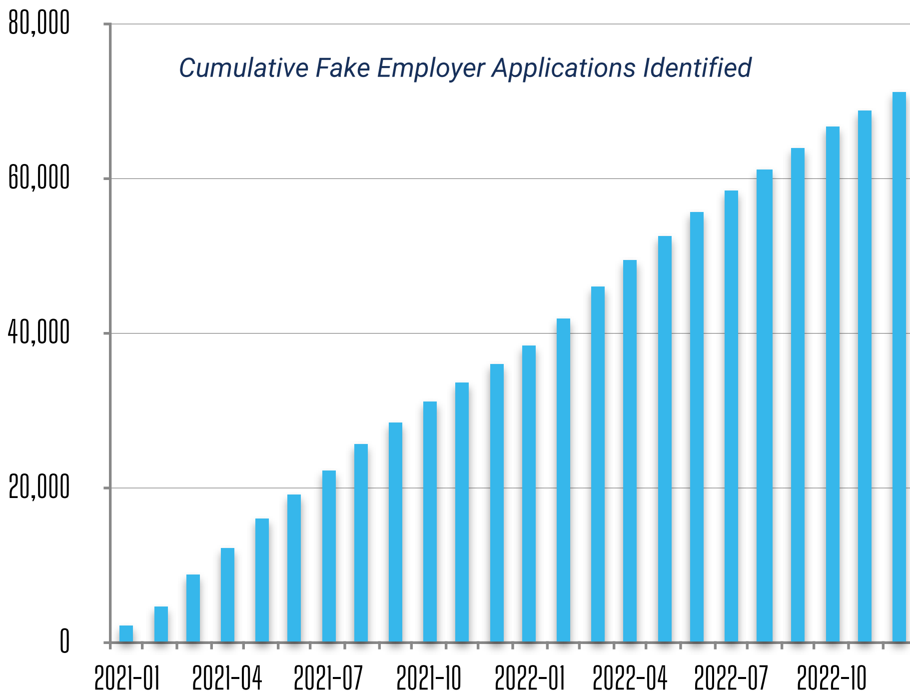
2) Unknown Or Miscategorized Fraud Risk

While credit unions have long focused on identity fraud, such fraud is approximately 20% of the overall fraud risk to auto lenders (obtain a copy of Point Predictive's 2023 Annual Fraud Report here). Because the focus on fraud has been so narrow, the majority of fraud risks are hidden within credit losses. Fraud is addressable, however. When properly defined, it is much easier to identify the red flags and prevent it before it can materialize.

There are many different fraud types that might slip through the cracks and credit unions which include:

Income Misrepresentation: A loan applicant might be exactly who they say they are, but they may inflate their income in order to get approved for the loan or get better terms. Income misrepresentation often has benign intent but, if the member can't afford the loan, it still results in default. If there is misrepresentation that influences a credit union's decision, and that leads to default, that should be considered as fraud.

Employment Misrepresentation: Whether it's lying about their occupation, trying to cover the fact that they may be recently unemployed, or even using known fake employers, employment misrepresentation is one of the fastest growing types of fraud in the auto lending industry. More than $2 billion in attempted fraud between 2020-2022 can be tied to fake employers.



$2bn in applications were received by auto lenders between 2020 and 2022 where a fake employer was used.

Credit Washing: Credit washing is the systematic, nonfactual dispute of derogatory trade lines in an attempt to boost credit or conceal prior fraud. Lenders have reported a sharp rise in credit washing since 2018, which was driven by changes in the FTC's requirements for identity theft reports.

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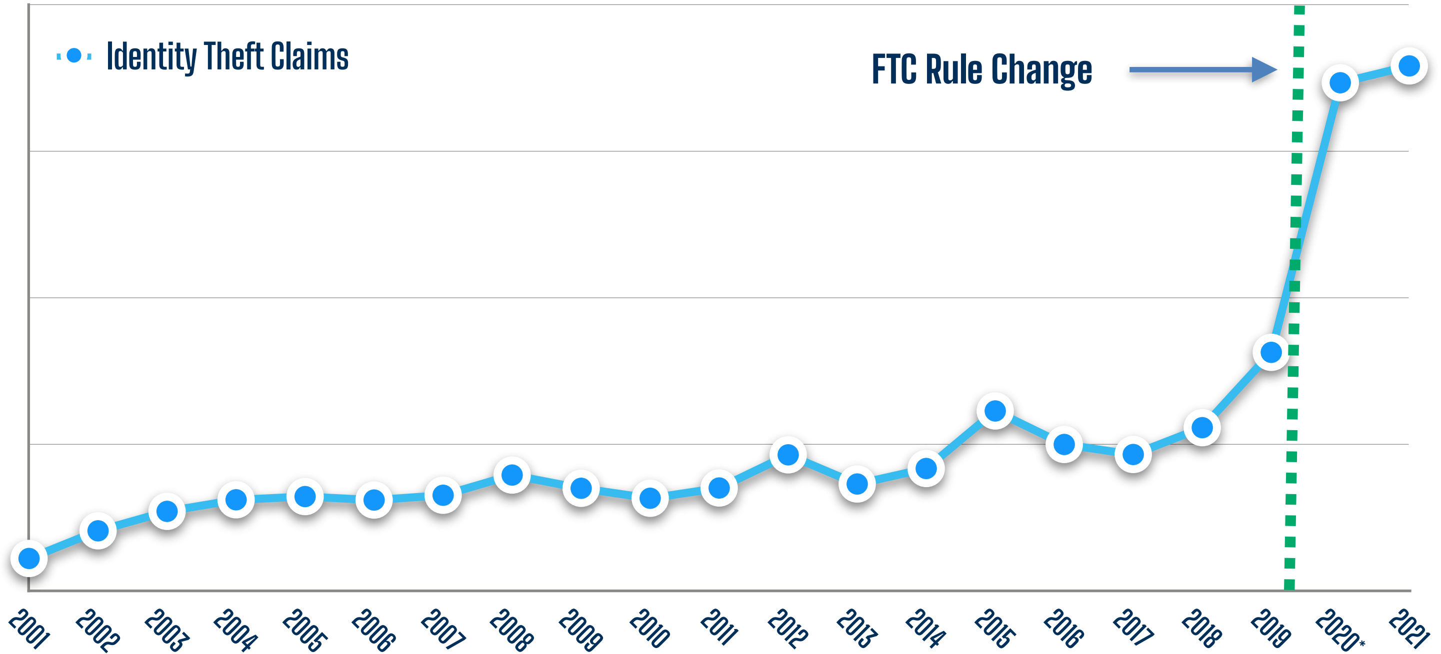
Under this new policy, consumers are no longer required to submit police reports to substantiate their claims; they could merely use an online affidavit and report it electronically. This led to a dramatic rise in claims at lenders - in some cases more than 400% over the year before. The problem is that an applicant's credit may look better on paper after being washed, but their behavior hasn't changed.



Synthetic Identities: Until recently, synthetic identity fraud wasn't a commonly known problem. These identities look perfect, with a strong borrower profile and established credit, but would always end in default.

Synthetic identity fraud is not a new phenomenon. but has been the biggest buzzword in the fraud world over the past couple of years. Credit unions are starting to take this type of fraud seriously, but there are a few who report hearing about this type of fraud just within the last year. Ultimately, synthetic identity fraud is easy to identify, but it requires access to granular credit level data and the ability to spot the red flags.

Some of these red flags include:

- Strong credit scores with very limited history or low time in file.
- Multiple addresses reporting at the same time, in different states.
- High ratio of authorized tradelines – also known as piggybacking.
- Older consumers who recently started reporting to the bureau, but should have more well-established credit histories.

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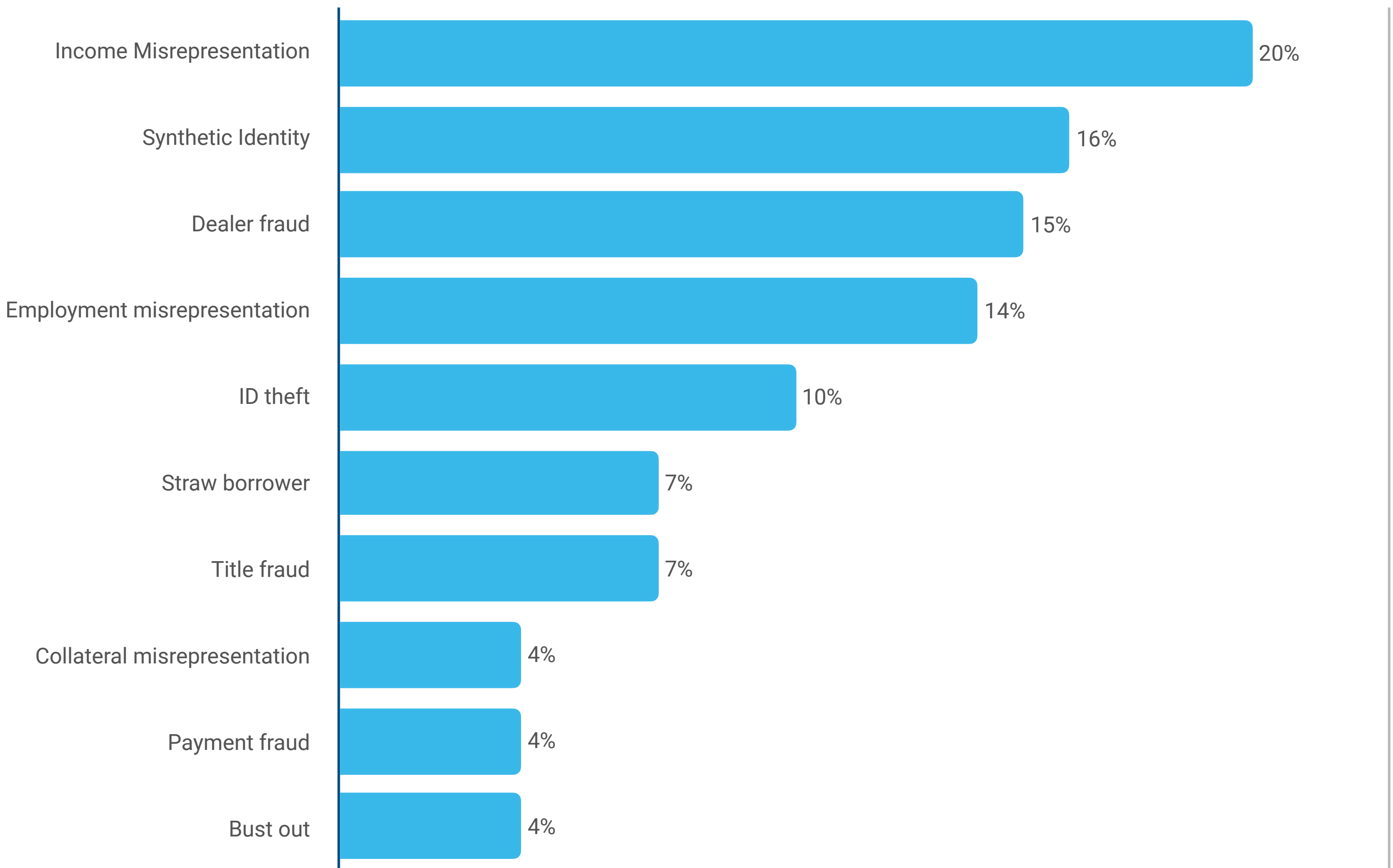
3) Indirect Lending Carries Much Higher Risks

Indirect lending introduces an intermediary in the loan process via the dealership, and the same controls that may have been in place through direct lending may not translate well to the indirect channel.

Dealers themselves can present their own fraud risks by being targets of fraud rings and, in some cases, even be complicit in the fraud. A recent survey conducted by Point Predictive found that 15% of indirect lenders surveyed stated that dealer-perpetrated fraud was their top concern. (Obtain a copy of Point Predictive's 2023 Annual Fraud Survey Results here.)

Managing dealer networks can be a demanding job, and in most cases, by the time a credit union has identified a bad dealer, it's too late. On average, it takes lenders more than six months to identify a bad dealership based on loan performance, which results in them having six months' worth of loans on book that have a high likelihood of defaulting and causing loss to the credit union.



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How Point Predictive Helps

As credit unions continue to expand into the auto lending space, Point Predictive is here to help with a range of tools to help identify qualified loan applicants, spot fraud, and manage dealer relationships. Proprietary data and industry expertise leverage machine learning and natural intelligence to identify current fraud trends and mitigate risks for clients.

Predictive scoring solutions identify auto loan applications most likely to result in default by examining deeper fraud reviews to understand the exact risks that are present on an application.

Point Predictive provides the most comprehensive risk solution platform on the market that helps credit unions automate all of their fraud checks in the background while minimizing friction and a bad member experience.

Our proprietary data is unmatched, providing 25 billion unique risk insights into borrowers and car dealerships that are not available on any other public records source.

If you'd like to decrease your risk profile, while expanding your portfolio profitably, reach out to us at info@pointpredictive.com

Automating Your Fraud Checks

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IncomePass™

Replace the pay stub with something better

DealerCheck™

Manage your dealer risk better

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POINT PREDICTIVE

Thank you

Point Predictive powers a new level of lending confidence and speed through the unique combination of artificial and natural intelligence using decades of risk management expertise.

Our technology solutions quickly and accurately identify who is reporting truthfully on their loan applications and who is not. As a result, lenders are now able to fund loans easily without asking the vast majority of applicants for onerous documentation such as paycheck stubs, utility bills or bank statements.

This improves funding rates by 40-50% while reducing overall early payment default losses by more than 30%. Borrowers get loans faster and we significantly boost profits to a lender's bottom line.

For more information, reach out to
info@pointpredictive.com

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