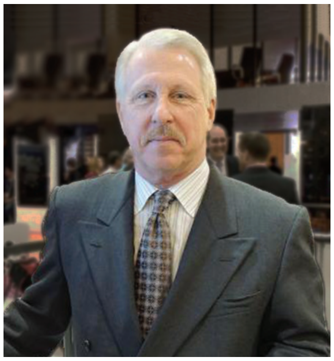
Dealer Reserve Not Doomed, Zurich Exec Says



Glenn Roberts, National Training and Business Development Manager for Zurich North America

Dealer reserve isn't doomed, but the beleaguered indirect-lending system needs to change in order to survive. So says Glenn Roberts, National Training and Business Development Manager for Zurich North America, a provider of dealership finance and insurance services. "I don't think dealer reserve's days are numbered," he tells WardsAuto. "If dealers follow our advice and the National Automobile Dealers Assn.'s advice, dealers will be able to keep it."

Dealer reserve, a.k.a. dealer participation, involves dealerships increasing auto-loan rates by varying percentage as compensation for acting as a middleman between the car buyer and lender. For instance, if a lender offered a 4% wholesale "buy rate," a dealer might add on 1% more or less, usually depending on the length of the loan. It is a long-standing practice that has come under fire by federal regulators, particularly the Consumer Financial Protection Bureau. That agency says an analysis it did shows dealer reserve practices – called "markups" by the CFPB and consumer advocates – have resulted in unintended discrimination against minority buyers.

Recently, Ally agreed to a nearly $100 million settlement in an unintended discrimination case stemming from the discretionary rate-setting practice of its dealer clients. CFPB contends minorities were charged higher rates than non-minorities, without credit scores as a factor. It has become a looming issue in auto lending. The CFPB advocates replacing dealer reserve with flat fees or something similar.

Dealer reserve can survive but with modifications, the most important of which is standardization taking away F&I office discretion in rate setting, says Roberts. Collaborating with the law firm of Hudson Cook, Zurich has launched a program to help dealers comply with fair-lending laws. The program consists of a risk-mitigating process to follow as well as software to keep track of results and monitor compliance. To reduce the risk of facing discriminatory and unfair lending charges, Zurich recommends dealers use a credit-score driven rate matrix. "You'll have various buy rates across the credit tiers," Roberts says. "That's a neutral issue; rates are higher for people with poor credit, lower for people with good credit." Accounting for that, the matrix works like this: A dealership sets a standard dealer reserve amount, say 1.5%. Whatever it is, it is applied across all credit tiers. "Spread it equally, like peanut butter across bread," he says. "That way, you are starting out with everyone on an equal footing," he says. By doing that, a store ends employee discretion in setting the final loan rate, a bane of the CFPB.

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As Bureau Pressures Lenders, Dealers Feel Heat

Zurich's recommended process allows dealers to lower a standardized dealer- reserve percentage, depending on market-driven factors. "For instance, a customer may say he can get a better rate at his credit union," Roberts says. "Matching or beating that deal is a legitimate downward deviation."

NADA proposes a similar program in an effort to keep dealer reserve alive. Standardizing rate reserve would take off much of the heat, Roberts says. "If we can't fix these issues as an industry, the government, particularly through the CFPB, seems ready and willing to dictate terms." He adds: "If dealer reserve is all discretionary, and we're getting bad outcomes, it will force the issue. Banks would say, 'We can't take this.' Dealer reserve would be gone. That would thrill the regulators." The CFPB directly oversees lenders, not dealers. But as the bureau pressures lenders, they do likewise to dealers.

One bank has established a 3-strike policy on unfair-lending matters. "If a dealer gets three letters saying they are discriminating, the bank terminates its lending agreement with the dealer," Roberts says. If the CFPB pushes harder, it may become a 2-strike policy. "But everyone is walking a fine line," he says. "Banks want the business. Dealers want to put cars on the road."

The CFPB works closely with the Department of Justice and Federal Trade Commission, which does directly regulate dealers. The federal agencies share information with state attorneys general. Today, a dealership with regulatory issues attracts a crowd. "You can't just fly under the radar," Roberts says. "In the past, you just had to be unlucky; someone would come into your store and find something or other." Now all dealership retail-installment contract information is sent to banks that are on the lookout for discriminatory-lending patterns. It started with the big banks doing that. Now, automakers' captive finance subsidiaries are monitoring dealers for such irregularities. Ford Motor Credit just sent dealers a letter to that effect.

Few dealers set out to discriminate against customers. CPFB allegations stop short of saying dealers willfully do that. Roberts says: "Dealers have told me, 'I'm not trying to discriminate against anybody.' My answer is that it's called disparate impact, meaning you are getting a bad result even though you are not necessarily trying to. "When I say that, dealers say, "That's good. I feel better.' And I say, 'Well, you shouldn't because even though you aren't intending to discriminate, you got a bad result and need to fix it.'"

The CFBP now shows an interest in what dealerships charge for F&I products and services such as extended-service agreements. The regulator seems unlikely to go so far as to set prices, but it is looking at dealer profit margins and how those might vary from customer to customer.

Other recommendations in the new Zurich risk-mitigation program are:

- Standardize product gross margins and lock down menus.
- Always quote a vehicle-only base payment opposed to a payment that includes F&I products too.

Melding F&I products into a quoted monthly payment is called payment packing. It was once common practice. Now, it's unequivocally illegal. "I remember when NADA asked me to do a workshop talking about payment packing and how you can't do it," Roberts says. "There were almost fist fights in these classes, with people saying, 'Why not?' Well, because regulators said it was a deceptive practice.' "But the industry adjusted and went to full disclosure, and what happened after that? Profits and sales went through the roof. I wouldn't be surprised if the industry sees the same thing when it makes adjustments to dealer reserve."

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Zurich

1400 American Lane, Schaumburg, Illinois 60196-1056
800 382 2150 www.zurichna.com

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