

## **Modified Auto Loan Underwriting Guidelines:**

**How to combine “maximum percent financing” and “risk adjusted rates” into an easy chart format – for improved service and profitability.**

This paper expands on the auto loan financing options discussed in the manual, “*Risk Based Lender – The Credit Union Solution*”. The manual covered three options: setting a maximum percent financing; using risk adjusted rates; and, developing a “hybrid” or combination of the two. Each method has its strengths and weaknesses.

As stated in the manual, my personal belief is that “**maximum percent financing**”, for each matrix level, remains the credit union’s best defense against default risk. Simply stated – higher risk members, with equity in their vehicle, are less likely to default on the loan. The downside of this method is that it does have a negative impact on member service since it results in a lower conversion rate – due to more credit union disapprovals and member withdrawn applications (who need full financing).

“**Risk adjusted rates**” will qualify and serve a larger portion of your membership. Although the immediate impact on the credit union is favorable (higher approval rates and increased loan income), the long-term impact “may” turn negative and result in higher collection/repossession costs and write-offs.

The third option is to offer a “**hybrid**” or blended program -- one that attempts to balance the needs of the credit union (collateralized lending) with the desires of the member (higher/full financing). Operationally, this option should also provide detailed guidelines – to ensure uniformity and fairness in the evaluation process – yet remain flexible enough to meet the varying needs of the membership.

The attached chart is one method that might prove useful for your credit union. It attempts to incorporate the benefits of both methods – while limiting the risks. It also uses clearly defined parameters – that are easy to understand and interpret – for all parties involved.

The chart begins with a basic foundation of “*maximum percent financing*” (based on that member’s matrix level), and then adjusts the interest rate to reflect the financing needs of the member. It also provides the option (and enticement) for the applicant to obtain a suitable cosigner in order to qualify for a lower interest rate.

Furthermore, the chart provides everyone at the credit union (board, management, staff, and members) with a simple-to-follow format that allows quick and easy placement for each and every loan applicant. That means less stress on your loan officers, greater consistency in the evaluation process, and a better member understanding of your underwriting guidelines.

**Explanation of Chart:**

- **Base Rate:** The normal rate that you charge for a specific model year/term loan. This is the rate that either your lowest risk borrowers' receive, or, the rate that all borrowers receive for that specific model year/term. For example, let's assume that your credit union has the following "Base Rates" for all borrowers on auto loans:

Term	2006 – 2007	2001 – 2005	2000 & older
0 – 36 months	5.00%	6.00%	7.00%
37 – 48 months	5.50%	6.50%	7.50%
49 – 60 months	6.00%	7.00%	
61 – 72 months	6.50%		

**Note:** The above rates are for illustrative purposes only and are not suggested or recommended auto loan interest rates.

- **Matrix Score – with standard financing:** This column refers to the member's matrix score – with the basic or normal "maximum percent financing" for that matrix level.

*For Example:* LL – 100%+ : means a "LL" borrower is qualified for 100% financing (plus dealer prep and taxes), whereas a "MH - 80%" borrower normally qualifies for 80% financing. Note that I have divided the "MM" category into thirds with different "percent financing" for each third.

- **Rate Only | With Co-Signer:** This column is split and shows the "risk adjusted rate" on the left – and the cosigner adjusted rate on the right. The member has the option of obtaining a co-signer, or, the credit union may require a cosigner as additional collateral.

For example: An "MH" applicant is normally entitled to 80% financing. If s/he applied for 65% or 80% financing – the normal "Base Rate" would apply. If however, s/he needed 100% financing on a 2006 auto with a term of 72 months (Based on the above chart, the "Base Rate" would be 6.50%) – the member could either:

- Receive the loan (with the desired financing) at 12.50% (Base Rate + 6%), or,
- Obtain a qualified cosigner to receive a lower rate. If the co-signer's matrix score was an "MM", the member could obtain the loan at 8.50% (Base Rate + 2%). (Note the MM is not broken down into thirds for cosigner adjustments).

**Remember:**

This chart is provided as "food for thought" – it gives you another option. An option that you can still refine and modify as needed. So, please feel free to use this as a starting point and customize the layout to fit your own credit union's underwriting guidelines.

### Enhanced Auto Lending with Multiple Financing Options

	<b>Loan Applicant is seeking:</b>				
Matrix Score-- with standard financing	100% Financing	80% Financing		65% Financing	
LL – 100%+	Base Rate	Base Rate		Base Rate	
LM – 100%+	Base Rate	Base Rate		Base Rate	
MM – 100%+ (Top Third)	Base Rate	Base Rate		Base Rate	
	Rate Only	With Cosigner	Rate Only	With Cosigner	
MM – 90% (Middle Third)	Base Rate + 2%	LL+0%	Base Rate	Base Rate	
		LM+0%			
		MM+1%			
		MH+2%			
		HH+2%			
MM - 80% (Bottom Third)	Base Rate + 4%	LL+0%	Base Rate	Base Rate	
		LM+0%			
		MM+1%			
		MH+2%			
		HH+4%			
MH - 80%	Base Rate + 6%	LL+0%	Base Rate	Base Rate	
		LM+0%			
		MM+2%			
		MH+4%			
		HH+6%			
HH – 65%	Base Rate + 8%	LL+0%	Base + 6%	LL+0%	Base Rate
		LM+0%		LM+0%	
		MM+4%		MM+2%	
		MH+6%		MH+4%	
		HH+8%		HH+6%	
LL & LM Cosigners: require at least 4 years credit history to be considered as a valid score HH Cosigners: not eligible for rate reductions – use as additional collateral on borderline loans					
Example: If an “HH” member (normal financing = 65%) needs 100% financing – you could either offer: 1) A rate adjusted loan at: “Base Rate + 8%”, or 2) Rate adjustment <u>with</u> a qualified MM cosigner at: “Base Rate +4%.”					