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Practicing Sound Loan Management in a COVID World

By Marina Hardy and Rick Vanko

The auto lending market faces significant challenges due to the COVID-19 pandemic. While auto lending's regulatory and legal obligations remain largely unchanged, lenders must operate in a disrupted U.S. economy.

The past decade has brought tremendous growth to auto lending; lending for cars, trucks, and SUVs rose more than 90 percent nationwide. And, as history indicates, whenever growth occurs, increased risk is rarely far behind. Auto debt is at a record $1.35 trillion, with the 90+ day delinquency rate currently at 5.1 percent and expected to climb higher as the pandemic continues.

The increasing volume of loan defaults and car repossessions has lenders concerned about managing higher loan portfolio risk while maintaining compliance with banking laws and regulations. How can auto lenders protect assets and better manage their loan portfolios in the wake of the pandemic's broad economic impacts?

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COVID-19 Regulatory Guidance

In response to the COVID-19 pandemic, federal and state banking regulators have taken steps to mitigate the risk. Regulators have encouraged lenders to work constructively with borrowers to help slow the rising default rates and to reduce the negative effects on the auto lending industry overall.

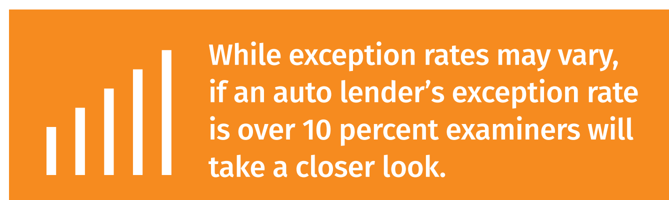
In June 2020, federal financial institution regulatory agencies, including the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the National Credit Union Administration, joined forces with state bank and credit union regulators to issue the "Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of the COVID-19 Pandemic on Institutions."

COVID-19 Regulatory Guidance

According to the joint guidance, "Examiners will continue to assess credits in line with the interagency credit classification standards, while recognizing the constraints posed by the pandemic. For instance, supporting file documentation may be limited due to unusual circumstances caused by the pandemic. When assessing asset quality, examiners should consider whether management has been able to identify loans and investments substantially affected by the pandemic and recognize any deterioration in a timely manner, including any potential loss exposure. Examiners will assess management's ability to implement prudent credit modifications and underwriting, maintain appropriate loan risk ratings, designate appropriate accrual status on affected loans, and provide for an appropriate Allowance for Loan and Lease Losses (ALLL) or Allowances for Credit Losses (ACLs), as applicable."

What this guidance seems to indicate is that expectations for managing loan portfolios will remain largely unchanged. Any declines in collateral values will be considered, but a borrower's ability to repay the loan remains key. The joint guidance also states that due to the "unique, evolving, and potentially long-term nature of the issues confronting institutions" from the pandemic, examiners will "exercise appropriate flexibility in their supervisory response."

Now that regulatory expectations have been established, examiners will follow through on this guidance in upcoming examinations. Lenders should ensure they understand the guidance to determine their institution's response is appropriate. If risk mitigation strategies have not yet been adopted, now is the time to step back and assess the institution's risk profile.



Consequences of Inadequate Credit Practices

Credit risk is the primary financial risk in the banking system, and the ability for a lender to manage that credit risk is critically important. Under federal law, a financial institution can face criminal charges for engaging in "unsafe and unsound banking practices." Enforcement agencies have typically viewed such practices as any action that exposes a financial institution, its customers, or its shareholders to the risk of loss that can qualify as a violation under federal law.

A Matter Requiring Attention (MRA) is an informal red flag that examiners use that, while less severe than an enforcement action, still signals that the financial institution has issues that must be resolved. If the MRA is not complied with, a regulator can place an enforcement action on the bank. Examiners expect a financial institution's board to ensure timely and effective correction of the practices that caused the concern and were cited in the MRA. These corrections include assigning responsibility, establishing processes to monitor progress, validating the effectiveness of the corrective actions, and holding people accountable.

Title 12, part 30 of the Code of Federal Regulations also provides guidance on safety and soundness standards. If a financial institution is found to be violating any aspect of 12 CFR 30, regulators can issue a cease and desist order for non-compliance.

As a rule, there needs to be ongoing dialogue and strategizing between a financial institution's legal and compliance teams to ensure the financial institution avoids potential risk. Oftentimes, silos exist in organizations that present significant hurdles to this coordination. However, legal and compliance teams must work together on credit risk issues, particularly when it comes to collections and repossessions, to avoid the consequences of non-compliance.

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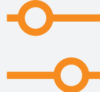
Advice for Lenders

It should be a financial institution's top priority to ensure that collateral is perfected, exceptions are addressed, and portfolio health is being proactively managed. There are several actions that lenders can take to protect their financial institution. A well-managed loan portfolio demonstrates to examiners that the financial institution is taking the necessary steps to mitigate credit risk vulnerabilities. Lenders should take these steps:

Adhere to sound collateral management strategies, including documenting lien perfections and valuation processes



Reassess quality controls, credit review, and internal audit functions and scopes

Keep policies and procedures regularly updated; include current information on the institution's risk appetite, metrics, loans/collateral to avoid, loan modifications, collection and repossession practices

Scrutinize and ensure compliance with third-party service providers

Proactively manage compliance risks related to credit, especially when examiners are paying even closer attention to ensure borrowers are being treated equally

Assess loan and collateral exception analysis and reporting

Examine and address ways to improve regulatory relationships

Handling Exceptions is a Priority

COVID-19 has had a significant impact on borrowers. In the U.S., three million people are in hardship status, and 100 million credit accounts are in relief. In May 2020, over 18 million people fell behind on credit card and auto payments. On top of that, long-term deferrals are coming to an end, and payment extensions are declining.

The result is that borrowers are struggling, and there is an expectation of increased repossessions on the horizon. With so much uncertainty, managing portfolio exceptions is going to be a priority. Nearly 25 percent of loans face perfection issues such as the lien holder not properly listed or not listed at all. If the loans are not properly perfected, trying to perfect them now, in the middle of a pandemic, will create delays for lenders because of backlogs at the DMV.

Additionally, jurisdictions have tightened requirements around various types of transactions. For example, it may have been acceptable to submit documentation missing a signature in the past, and the DMV clerk would still accept it. However, those days are over. Now, if documentation is not done properly or items are missing, it will be returned, adding even more time to the process.

3M people are in hardship status

$100M credit accounts are in relief

While exception rates may vary, if an auto lender's exception rate is over 10 percent examiners will take a closer look. To protect and perfect motor vehicle collateral, it's important to address all motor vehicle exceptions, account for any processing delays due to DMV backlog, and consider process optimization and/or outsourcing exceptions to a vendor that can guide you through your outstanding perfection issues.

Now is the time to be proactive. It has never been more critical to understand your processes, review your exceptions, and take action before a repossession happens.

About Lien Solutions

Wolters Kluwer Lien Solutions, which is part of Wolters Kluwer's Governance, Risk & Compliance (GRC) division, provides award-winning solutions for lenders. Its flagship iLien offering gives lenders the ability to conduct public record searches, retrieve and view UCC and corporate records, create filings, and manage their entire lending portfolio. Its iLien Motor Vehicle offering is an award-winning SaaS platform that transforms vehicle and equipment titling work, helping lenders maintain loan perfection, monitor and manage vehicle liens efficiently, and release titles effortlessly.

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