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Risk Management Strategies for Captive Lenders in a Financial Crisis

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Since the advent of modern consumer protection law in the 1960s, the financial services sector has been one of the most heavily regulated industries in the nation. Predatory real estate lending that triggered the Great Recession has driven a new wave of consumer protection legislation aimed at leveling the playing field for lenders and individual borrowers. But, in the auto finance industry this trend is expressed differently: fraud-prevention requirements hitherto imposed on dealers are being relaxed and the risks of dealer fraud shifted to captive lenders, all in the name of consumer protection. Lenders' options for insuring this increased crime risk may be limited, calling for heightened scrutiny of crime insurance policies intended to backstop this exposure.

A "captive" finance company is a lender owned by a product manufacturer and created for the sole purpose of making dealers' and customers' purchases of products more convenient. Captive auto lenders provide "floor" financing to dealers, allowing them to buy their inventories with borrowed funds. Captive lenders also offer financing for consumer purchases of the parents' products, and serve an important role in the car, truck and equipment stream of commerce. Captives tout their ability to tailor terms and incentives for auto buyers better than other financing sources. They lend money to dealers and car buyers without relying on insured deposits. They are licensed by the states and highly regulated at both the state and federal levels. Compliance with federal regulations alone requires an encyclopedic knowledge of the Truth in Lending Act, Consumer Leasing Act, Credit Practices Rule, Equal Opportunity Credit Act, and the Federal Trade Commission's Credit Practices Rule. Captive lenders are, and should be, confident in their ability to play an important role in meeting the financing needs of wholesale and retail buyers of vehicles.

Yet, complex 50-state regulation of captive lenders can place them at a competitive disadvantage relative to other kinds of auto lenders, sometimes driving captives out of certain states entirely. To counter this, captive lenders have to master the regulations governing their business and take steps to control their enterprise risks. A major risk is being defrauded by an auto dealer. Relaxing of statutory fraud-prevention measures imposed

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on dealers reduces controls in effect to prevent a dealer from committing fraud. While dealer scams involving financing hurt consumers and lenders alike, the burden of loss usually flows down to the captive lender. The risk of loss to a captive lender from dealer fraud is difficult to insure, and requires carefully designed internal controls as well as a crime insurance program tailored to the captive lender's exposure to dealer fraud.

In the typical manufacturer-captive lender-dealer relationship, the customer belongs to the dealer. The captive finance company does not have the opportunity to communicate with the customer until after the dealer has underwritten the financing contract and chosen to sell the contract to the lender. Dealers are independent businesses that have an authorized franchise with one or more auto manufacturers. They do not work for the manufacturer; the manufacturer does not own the dealership. Only dealers are licensed to directly negotiate financing terms with customers. Dealers are responsible for primary verification of identity and credit history of the prospective borrower, and for perfecting liens securing consumer loans.

New legislation under consideration in Congress and in several states could excuse dealers from their obligations as a creditor to verify credit and borrower identity. The new rules would transfer such duties away from the loan-originating dealers to the finance companies, because the finance company is the ultimate purchaser of the contract and assumes the credit risk over the life of the contract. These regulations could signal a general loosening of controls on dealers, increasing the risk of customer and dealer fraud. They also appear to reflect a shift in regulatory attention away from dealers, and toward lenders. This change in climate may make dealer fraud easier to perpetrate and harder to prevent.

The captive lender's first line of defense against dealer fraud is the contract between them. This contract should articulate the lender's remedies in the event of dealer default or misconduct. Good fences make good neighbors. Paying attention to how dealers are operating their businesses, borrowing to finance wholesale purchases, and underwriting consumer loans for product purchases are the lender's best means of preventing frauds. Does the dealer faithfully match up loan contracts with collateral so vehicles cannot be double-pledged to secure multiple loans? Does the dealer make payments on any loan, suggesting that the borrower is fictitious and the loan proceeds have been diverted to the dealer's private use? Good internal controls should include detail-oriented loan underwriting by the captive, spot checks of loan pipelines from dealers, and the right to audit dealers where there are questions.

But dealers, especially car dealers, are politically adroit, well-organized, and often willing to use their influence over the manufacturer to avoid burdensome internal controls aimed at protecting lender subsidiaries. As a result, even as captive lenders negotiate safety nets with dealers to reduce the risk of fraud loss, they must make dealer-lender contract rights part of, and not the total of, a unitary risk management strategy.

Certain kinds of dealer fraud losses cannot be contractually shifted away from the lender. For example, the Federal Trade Commission's Rule Concerning Preservation of Consumers' Claims and Defenses, commonly known as the Holder Rule, is one area of risk that typically cannot be contracted around and for which captives must ensure they have adequately assessed risks. Under the Holder Rule, if a dealer made misrepresentations in selling a car on credit, or engaged in fraud, a consumer could raise the dealer's conduct as a defense to a captive lender's demand for payments. The Holder Rule requires dealers to give notice to consumers in credit contracts that lenders who buy the contracts are subject to the same claims and defenses the consumer would have against the dealer if the lender bought the credit contract in good faith and without knowledge of the claims and defenses, effectively making lenders liable for dealer conduct, and shifting the loss to the captive.

Critical to buttressing available contract-remedies, is purchasing comprehensive crime coverage that insures against dealer fraud on the lender, and on consumers that creates liability for the lender. As a rule, a typical crime insurance policy sold to a manufacturer is very narrow in scope. It covers losses from employee dishonesty to money stolen from the policyholder's premises, among other perils. Captive lenders should make sure they are not simply added to the parent manufacturer's commercial crime policy without first checking whether the coverage is right for a financing company. A policy that covers stolen inventory but not stolen electronic transfers of funds may not be appropriate for a lender. Similarly, a captive lender should think long and hard before buying a policy written for banks, since depository coverage (coverage for money and property held in a safe or vault for customers) and check fraud coverage may afford little protection for the risks faced by captive lenders.

Far more important for a captive lender is crime insurance that covers dealer fraud. Many commercial crime forms exclude all losses in any way associated with people or entities representing the manufacturer or its captive lender. As originator of all lending contracts financed by the captive lender, the dealer has a unique ability to fraudulently divert the lender's flow of funds. A crime policy excluding losses caused by dealers may not do much to mitigate the lender's risk of a crime loss. Inappropriate products, like insurance designed for industries other than lending, can create a false sense of security for the captive attempting to manage risk.

Properly valuing risk for insured losses and putting appropriate insurance in place to cover it is the first stop on the road to effectively managing a captive lender's risk of crime loss. Now is the time for the captive lender's general counsel and risk manager to make sure the crime insurance on which their company relies to mitigate the risk of dealer fraud is tailored to its needs – not to the needs of other industries.

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