To: National Credit Union Administration

From: Capital Lending, Dan Phillips

Re: 7535-01-U, Third-Party Servicing of Indirect Vehicle Loans

The purpose of this memo is to provide a feedback regarding the above proposed NCUA rule.

We believe that compliance with the NCUA Risk Alert 05-RISK-01, Specialized Lending Activity – Third-Party Subprime Indirect Lending and Participations, significantly addresses the risks related to credit unions involved in Third-Party Subprime Lending activities and encourage all credit unions to comply with this Risk Alert, such that compliance may negate the need for capital limitations.

Capital restrictions may be appropriate for certain Third-Party Subprime Lending activities in which the credit union has given a third party program provider significant control over the loan assets. We do not believe that all Third-Party Subprime Lending programs possess these attributes and therefore do not require similar capital restrictions.

The following analysis describes certain indirect lending program components. It also addresses the different ways in which these components can be delivered, and what we believe are important differences in risks to the credit unions related to these different delivery methods.

Credit Risk – *More Permissive Underwriting Criteria than used in Direct Lending*

We understand that a Third-Party Subprime Lending program model sponsor may control the origination and underwriting processes. This could be accomplished by the program sponsor developing the underwriting criteria, negotiating the auto financing contract directly with the car dealerships through the program sponsor's relationships, making the underwriting decision, and funding the loan. In such a case, the origination and underwriting functions are performed with very little credit union involvement. This type of program significantly prevents the credit union from participating in the origination and underwriting processes in a meaningful way and potentially increases program risk of using more permissive underwriting criteria than the credit union uses in its direct lending.

There are indirect programs where the credit union participates fully in the origination and underwriting processes. In these programs, the credit union ensures that the underwriting criteria are consistent with their internal guidelines on the front end, the indirect origination process is accomplished through the credit union's dealer relationships, automated underwriting decisions are made using the criteria pre-approved by the credit union and independently verified by a recognized independent third party, and the funding of the loan and verification of STIPS are performed by the credit union.

In this type of program, the credit union is an integral part of the origination and underwriting processes from the beginning to the end. Accordingly, the credit union is able to assess the credit risk as well, if not better, than one of its internal origination programs that may not be subject to as rigorous scrutiny from as many parties.

Liquidity Risk- *Unexpected Origination Increases and Restricted Ability to Transfer Servicing*

A credit union must manage its indirect volume of loan originations. As noted above, in certain programs the credit union may not control the origination process and may in fact experience an unexpected sudden increase in indirect, outsourced loan originations. In other scenarios in which the credit union is involved in the origination process, the third party program provider is not a significant factor in determining origination volumes because the dealer relationships and funding activities are in the control of the credit union.

As far as the ability to transfer the third-party servicing, there are third-party servicing contracts available to the credit unions for servicing indirect auto loans in which the credit union simply provides the servicer with commercially reasonable notice (reasonable in the sense of identifying a replacement servicer and performing an orderly transfer of the servicing) to effect a servicing transfer. These servicers also provide performance standards directly to the credit union for the servicing of the loans. We believe that CenterOne Financial Services sets the standard in the industry.

Transaction Risk – *Reliance on Internal Controls, Systems and Processes of 3rd Party Servicer*

We agree that counterparty risk is inherent in utilizing a third-party to perform outsourced functions. We believe these risks are outweighed by the benefits of having a direct relationship with an experienced servicer, independent of the indirect program sponsor. The risks can be mitigated through due diligence and monitoring of credit ratings and review of SAS 70 opinions.

Compliance Risk – *Consumer Protection Laws*

The credit unions are subject to consumer protection laws, such as the Truth in Lending Act and the Fair Debt Collection Practices Act. Related to the transaction risk noted above, the credit union should perform its due diligence to satisfy itself that this risk is and will be met by the third-party servicer. This compliance should be covered in the servicing contract, servicing standards and can be monitored periodically by the credit union.

Reputation Risk – *Poor Quality Servicing, Improper Collection Processes, and Questionable or Excessive Fees*

The credit union must monitor the third-party servicer for poor quality servicing and improper collection processes. These processes can be monitored through analyses of the servicing reports and auditing of certain transactions for regulatory compliance. In certain third-party servicing contracts, the credit union receives all of the fees assessed against the borrower by the servicer, which are not permitted to be in excess of statutory limits.

Loss of Servicing Control – *Similar to Asset Backed Securities*

We respectively submit that the purpose of creating Asset Backed Securities (ABS) is to reallocate existing risk and reward of a loan portfolio across the various securities created to investors with different risk appetites. The risks are segregated and then allocated among the various component securities for the purpose of creating certain securities with lower risk profiles than the underlying collateral as a whole, and other securities containing greater risk profiles than the underlying collateral as a whole. Typically, the issuer retains the securities that contain the highest risk components.

The way in which certain securities can be created with a better risk profile than the portfolio taken as a whole, is to have other securities within the transaction absorb a higher proportion of risk to provide support for the enhanced securities.

The objective of every ABS transaction is to be as efficient as possible and to provide as much comfort and protection as possible to the potential investors. A significant factor in providing such comfort is obtaining a servicer with a good reputation in the industry and with financial stability. Many times the issuer is the servicer, but in other instances the market demands that the servicer be a third-party servicer. But in any event, the objective in determining the servicer is to find a satisfactory servicer who will minimize risk in the transaction.

Accordingly, the presence of a third party servicer in an ABS transaction is not viewed as an additional risk factor created because the issuer has given up control, but rather as an added benefit. This is because the servicing is being performed by an independent third-party directly accountable to the transaction, who specializes in servicing the asset class, whose future is solely linked with proper servicing results (which must stand the test of time to attract future business) and who provides greater ability to the structure by enabling the transfer of ownership of the securities without an interruption in the servicing and collection process.

Therefore, we believe that a credit union who directly contracts with a third-party servicer, with an experienced track record of servicing the asset class and who can demonstrate financial strength is a prudent action. Obviously, the credit union must perform the necessary due diligence to determine the adequacy of the third party servicer. These due diligence procedures are noted in the Risk Alert. 05-RISK-01.

As noted above, the risk profile of an investment in an ABS security can range from a credit enhanced highly rated bond, to a credit subordinated bond with a poor credit rating.

Therefore, it is difficult to equate risk of an indirect auto loan portfolio for which the servicing has been outsourced to an investment in a particular ABS security (which may be either enhanced or subordinated) because of the wide range of risks inherent in the various potential ABS securities.

We agree there can be a difference between the risk profile of an indirect auto loan portfolio with outsourced servicing and an investment in a particular ABS security, but the difference typically would not be related to the outsourced servicing (where the outsourced servicing risk is considered minimal).

Conclusion

In conclusion, we think that the proposed capital limits may be appropriate for an indirect third-party program in which the program provider controls the origination, underwriting and servicing functions. But the above proposed regulations may be over-broad as applied to all credit unions; in that the regulations may unjustly prohibit credit unions from engaging in otherwise safe and sound lending and servicing practices.

We believe that for indirect third-party programs in which the credit union participates in the underwriting process, uses its own dealer relationships for originations and contracts directly with an independent financially sound servicer with appropriate asset class experience, the credit union's risk profile is not significantly different from its internal programs and therefore should have similar capital limitation requirements.