Auto Direct Lending on the Upswing

January 31, 2019 | Nicole Munro and Nora Udell

It's the time of year for predictions and several recent headlines have signaled that traditional auto finance may have a competitor moving in - direct lending.[1] In recent months, we've seen traditional and non-traditional finance sources jump into the direct lending marketplace.

But isn't that what finance companies do - auto lending? Not exactly. Is the difference important? Yes, yes, a thousand times yes.

Auto secured retail installment sales (i.e. indirect sales financing) and auto secured loans (i.e. direct lending) are different financial products. Although compliance obligations are similar, the obligations are not the same because direct and indirect lending programs are often governed by different state law and federal laws apply differently to the products.

First, a refresher.

A **loan** is a direct transaction between a "lender" and a "borrower." The borrower may use the loaned money to buy a car from a dealer. The terms of the loan are set out in a promissory note. In a loan, the lender charges the borrower interest on the principal balance of the loan. The Truth in Lending Act ("TILA") federal box disclosures must contain the following 4 important terms boxes along the top of the model disclosure:

- APR,
- Finance charge,
- Amount financed, and
- Total of payments.

A **retail installment sale** is a transaction in which the "buyer" buys a car from the "retail seller." The terms of the sale are set out in a retail installment sale contract, not a promissory note. In the retail installment sale contract, the buyer promises the retail seller that he will pay for the car over time. The seller must perform the terms of the contract, as long as the seller holds the contract. In indirect sales financing, the dealer sells the retail installment sale contract to a sales finance company or financial institution soon after origination. In a retail installment sale, finance charges accrue on the amount financed at the contract rate. The calculation is different from a loan and a credit sale's TILA federal box disclosure must contain the following 5 important terms boxes along the top of the model disclosure:

- APR
- Finance charge
- Amount financed,

- Total of payments, and
- Total sale price.

The nuts and bolts of indirect retail installment sale and direct loan transactions fit together differently. For example, the dealer is the original creditor in a retail installment sale transaction. The dealer assigns the contract to a third-party finance source (often mistakenly referred to a lender). In direct loans, a licensed lender or financial institution funds the purchase of a vehicle from the dealer. The lender is the original creditor. The dealer does not participate in the extension of credit. Because of these differences, indirect and direct transactions raise similar, but not identical, compliance requirements.

Compliance

Clarity about whether the transaction is indirect financing or direct lending is important throughout the transaction. TILA disclosures, applicable state laws, including rate caps, and required notices may differ based on whether the financial product is a loan or a retail installment sale. For example, in New York, the criminal usury limit on a loan made by a licensed lender is 25%, but that rate cap does not expressly apply to a retail installment sale. In addition, compliance obligations in a direct lending transaction differ based on the identity of the lender - whether the lender is a state-licensed lender or a bank or credit union.

Laws that govern retail installment sale contracts versus loans often differ within a state. For example, in Texas, Chapter 342 of the Texas Finance Code governs consumer purpose auto secured direct lending if the interest rate exceeds 10%. Authorized lenders, including licensed lenders and financial institutions operate under Chapter 342. In contrast, vehicle secured installment sale transactions are governed by Chapter 348. Dealers and finance company holders must hold a sales finance license and must comply with Chapter 348. Banks may buy vehicle secured installment sales without a license, but arguably must comply with Chapter 348 substantive limitations, at least to the extent the provisions make up the terms of the contract.

In addition to applicable law, processes differ. For example, in an indirect financing transaction, the dealer is typically responsible for titling and registering the vehicle. However, in a direct lending transaction, the lender will either have to make arrangements with the dealer to file the paperwork with the state or establish different policies and procedures to ensure its name appears on the vehicle title as a lienholder and that the vehicle is properly registered.

In indirect transactions, compliance with the federal Equal Credit Opportunity Act and Regulation B comes up in the context of "dealer participation" or "dealer markup." Dealer participation is when a dealer marks up the interest rate on a buyer's contract from the indirect finance source's buy rate and retain the difference. The practice intersects with fair lending when the markup is alleged to be applied more often in contracts entered into with members of protected classes (e.g. women, the elderly). Although dealer markup is not an issue in direct lending transactions (because there is no buy rate between a direct lender and a dealer), fair lending risk does not simply disappear for direct lenders. Direct lenders must continue to monitor for fair lending risk in their own advertising, underwriting and servicing practices.

Why the interest (no pun intended) now?

You may ask why the auto finance industry is moving toward direct lending platforms in addition to or instead of the traditional indirect model. One catalyst may be consumer demand. The way consumers buy cars is changing - it's moving out of dealerships and the F&I office into consumers' homes and onto their smart phones. Consumers look for cars online and they shop for financing online, too. When consumers shop for financing, they're looking for financing options that they can access *before* going to the dealership. For finance sources that want to reach consumers directly and sooner in the car-buying process, instead of through dealerships toward the end of transaction, direct lending may provide that opportunity.

Online car buying companies and manufacturer direct retailers are also partnering with direct lenders to sell and finance vehicles. With increased interest in fully electronic transactions, lenders want to keep up with technology and innovation. Finally, a bank lender can export interest from its home state and utilize preemption of state laws to standardize loans across states rather than adhere to state retail installment sales terms and conditions. Whether this shift will take off is yet to be seen, but we are definitely getting more calls and requests for advice from those looking to enter the direct auto lending marketplace.

____

[1] *See e.g.* "Auto Financing Finally Shifts into the 21st Century," American Banker, January 7, 2019, *available at* https://www.americanbanker.com/news/auto-financing-finally-shifts-into-the-21st-century.; "Catching the Wave: The Impact of Direct Lending on Auto Finance" Auto Finance News, November 28, 2018, *available at* https://www.autofinancenews.net/catching-the-wave-the-impact-of-direct-lending-on-auto-finance/.

Hudson Cook, LLP is a national law firm representing the financial services industry in compliance, privacy, litigation, regulatory and enforcement matters.

7037 Ridge Road, Suite 300, Hanover, Maryland 21076
410.684.3200

hudsoncook.com