Communication Between Federal Reserve Board Staff
and National Automobile Dealers Association (NADA)
October 1, 2010

Participants: Karen Pence (Federal Reserve Board)

Paul Metrey (NADA)

Summary: Staff of the Federal Reserve Board received from NADA comments regarding risk retention requirements on auto securitizers. A copy of the comments provided by NADA is attached below.

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Legal & Regulatory Group

October 1, 2010

Via E-Mail

Karen Pence
Chief, Household and Real Estate Finance
Board of Governors of the Federal Reserve
Washington, D.C. 20551

Re: Risk Retention Study

Dear Ms. Pence:

The National Automobile Dealers Association ("NADA") submits the following comments concerning the Study on Risk Retention that must be conducted by the Board of Governors of the Federal Reserve System ("Board"), in coordination and consultation with the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairperson of the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission ("SEC") (collectively, "the agencies"), pursuant to section 941(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

NADA represents over 16,000 franchised dealers in all 50 states and the District of Columbia who (i) sell new and used automobiles and trucks; (ii) extend vehicle financing and leases to consumers that routinely are assigned to third-party finance sources; and (iii) engage in service, repair, and parts sales. Our members, a significant number of whom are small businesses as defined by the Small Business Administration, collectively employ approximately one million people nationwide.

NADA offers these comments to highlight the negative consequences that could result from (i) the regulatory imposition of risk retention requirements on auto securitizers, and (ii) the regulatory allocation of a portion of that risk to franchised car and truck dealers who originate and assign credit and lease contracts to auto securitizers.

Imposition of risk retention requirements on auto securitizers

NADA shares the concerns expressed in the record by auto securitizers regarding the significant harm that could be caused by the regulatory imposition of well-intentioned but ill-advised risk retention requirements on auto securitizers. *See, e.g.*, Meeting Between Federal Reserve Staff and Representatives of Ford Motor Credit Company (Aug. 18, 2010); Comments of 16 Auto Finance Companies ("Vehicle ABS Sponsors") to the SEC on Proposed Rules for Asset-Backed Securities, File No. S7-08-10 (Aug. 2, 2010). As expressed in detail in these submissions, although the imposition of a "vertical slice" risk retention obligation may be appropriate for other asset classes, it (i) is not necessary to protect auto ABS investors and consumers based on the robust protections that already exist in auto securitizations, and (ii) would likely cause harm by restricting consumer and small business access to affordable credit.

The need for affordable credit is essential both to sustain the operations of franchised car and truck dealers and to recover from the economic stagnation that continues to afflict the auto industry. Vehicle sales are heavily dependent on consumer access to affordable credit, with 94% of all new vehicle deliveries being financed or leased. In the years prior to the economic crisis of 2008, franchised car and light-duty truck dealers consistently sold or leased well over 16 million new vehicles per year. This number dropped to 10.4 million in 2009 and is only expected to increase to approximately 11.5 million in 2010.[1] While a number of conditions created this sudden drop and have stymied the rebound, the unavailability of affordable credit to many consumers who are not in the top credit tier has been and continues to be a significant contributing factor.[2]

In addition to consumers' need for retail credit to purchase cars and trucks, dealers require wholesale inventory ("floorplan") lines of credit to purchase vehicles from their manufacturers and to keep new and, increasingly, used vehicles on their lots. During the height of the credit crisis, several large finance sources ceased to offer or significantly curtailed their floorplan lines of credit to dealers, which caused many dealers to close their businesses. Although the situation has substantially improved, the universe of auto floorplan lenders remains relatively small and is heavily concentrated in lenders that rely on securitization, and very few have sought to expand this line of business. Further, because dealers' profit margins on the sale of new vehicles remain very thin (and are negative during recessions), many are not in a position to absorb an increase in the interest rates they pay to their floorplan lenders. Consequently, disruptions to either the availability or the cost of floorplan credit could cause significant harm to franchised dealers and to the manufacturers from which they purchase their new vehicle inventories.

The need for an efficient ABS market to ensure dealers and their customers have access to affordable credit is aptly illustrated by auto securitizers' extensive use of this funding mechanism. The market for auto floorplan securitization has nearly returned to pre-crisis issuance and spread levels. Last week, both Ford Credit and Ally Bank issued 3-year term securitizations at spreads of less than 100 basis points, which compares favorably to issuances in the TALF program at approximately twice these levels. This is tremendous progress since, during the financial crisis, the term ABS markets were effectively closed. Should ABS transactions become less attractive to these finance sources, it would result in floorplan lenders borrowing at a higher cost of funds, which in turn would result in dealers and consumers paying higher interest rates. Although such a result would be problematic at any time, it would be

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1 Current estimate of NADA Chief Economist Paul Taylor.

2 For additional information on economic conditions affecting franchised car and truck dealers, see *NADA Data 2010*, available at www.nada.org.

particularly damaging in the present environment and would further hamper the industry's sluggish recovery.

Allocation of risk to franchised car and truck dealers

In addition to our concerns about the consequences of imposing regulatory risk retention requirements on auto securitizers, we are similarly concerned about the adverse consequences that would result from the allocation of a portion of the retained risk on franchised dealers who originate and assign auto finance and lease contracts to finance source securitizers (a process referred to in the industry as "three-party vehicle financing").

The possibility of such an allocation arises from section 941(b) of the Dodd-Frank law, which requires that the SEC's and federal banking agencies' risk retention regulations provide, as they jointly deem appropriate, for "the allocation of risk retention obligations between a securitizer and an originator in the case of a securitizer that purchases assets from an originator…." The apparent purpose of this provision is to provide an incentive to originators to engage in sound underwriting before assigning loans to securitizers.

As the following analysis of three-party vehicle financing transactions illustrates, however, allocating a portion of the credit risk to dealer-originators would not serve this purpose and would only result in the imposition of redundant and unnecessary costs on auto and truck dealers who are not in a position to assume additional financial burdens.

Three-party vehicle financing transactions provide an efficient means for finance sources to outsource to dealers the marketing and delivery of their financial products to consumers. It also provides consumers the convenience of arranging financing through the same dealership from which they purchase their vehicles. This optional means of financing has provided millions of consumers with access to competitively priced credit for their vehicle purchases.

The efficiency that makes it cost effective for finance sources to outsource to dealers the retail distribution of their financial products exists because each creditor involved in the finance transaction (the dealer as the initial creditor and the finance source as the assignee creditor) performs distinct functions that do not overlap and that match their respective capabilities.

Dealers establish relationships with prospective vehicle purchasers, take their applications for financing, and send the applications to either some or all of the many finance sources with which they conduct business (typically determined by matching the consumer's credit report to the finance sources' lending parameters). Finance sources thereupon conduct thorough and highly sophisticated underwriting on the finance applications they receive using their own proprietary systems, which include an analysis of risk-based factors such as loan-to-value and debt-to-income ratios, verification of employment, and routine entries on the applicant's credit report (e.g., credit score, number of delinquent accounts, bankruptcy filings, etc.). Based on this analysis, the finance source determines whether, and at what wholesale rate, it will take assignment of the credit contract from the dealer. For consumers whose credit applications have been approved by at least one finance source, dealers will offer financing at a retail rate and, if the consumer consents to the terms, enter into a credit or lease contract with the consumer and then immediately assign it to the finance source.

Dealers thus do not consummate the credit or lease contract with the consumer until after the finance source has conducting underwriting and agreed to take assignment of the contract. This arrangement is necessary as dealers typically are not equipped to either serve as their own finance source or conduct the necessary underwriting.

The retail rate that is offered to the consumer reflects the separate functions performed by the finance source, in its capacity as the underwriter and source of the funds for the vehicle purchase, and the dealer, in its capacity as the retail distributor of the financial product. The wholesale "buy" rate set by the finance source includes the entire risk premium, along with the finance source's costs of funds, loan production costs, and return on investment on its costs. The retail margin that the dealer adds to the wholesale buy rate (known in the industry as "dealer participation") does not include a risk premium, but rather consists of its loan distribution costs and return on investment on those costs.

Other characteristics of these originations also contribute to the strength and reliability of this lending model. With regard to finance sources, they (i) understand they are lending against a depreciating asset which in turn requires their underwriting process to focus on the borrowers' repayment ability, (ii) do not engage in the originate-to-distribute model that section 941 is designed to address, (iii) already retain a first-loss position with regard to their ABS as demanded by the market, and (iv) have an unblemished ABS performance record even during periods of economic instability.

With regard to dealers, they similarly have ample incentive to avoid entering into and assigning credit and lease contracts that may end up in default, as they would (i) forfeit a far more significant amount of prospective income from disgruntled customers who choose not to use the dealer to either service their vehicle or for future vehicle purchases (the "customer for life" concept), (ii) strain their relationship with finance sources whose willingness to finance future vehicle purchases and extend floorplan financing may be critically important to the dealer's ability to execute its primary business purpose (selling vehicles) and to maintain vehicles on its lot, and (iii) typically lose the unearned portion of the dealer participation if the default occurs during the initial stage of the credit contract (usually 90 days).

These combined factors have produced a three-party financing model that has resulted in the origination of millions of responsible vehicle finance and lease contracts, very low default rates relative to other asset classes, and the protection of ABS investors and consumers. Most importantly, it has not produced any of the factors that would support either the regulatory imposition of risk on auto securitizers or the regulatory allocation of a portion of that risk to franchised dealers.

Aside from the absence of problems that would warrant such regulatory intervention, the allocation of a portion of the retained risk to dealers would do nothing to strengthen the vehicle financing underwriting process. Quite simply, dealers possess neither the personnel nor the systems to perform sophisticated underwriting, and there is no need for them to assume this redundant function as it already is more than adequately performed by the finance source before the contract is even consummated.

Thus, the net result of such an allocation would not be more responsible underwriting, but rather less capital that would be available to franchised dealers. This is because any requirement that dealers retain a portion of the risk of loss of the entire income stream due to the finance source (as opposed to the risk of loss of only the dealer participation) during the full term of a finance or lease obligation would significantly increase their loss exposure and cause them to create cash reserves to satisfy this greatly enhanced contingent financial liability. Such a harmful result, particularly when unaccompanied by any benefit to investors or consumers, should be avoided in the agencies' forthcoming risk retention rulemaking.

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For the foregoing reasons, we urge the Board, in consultation with the agencies, to incorporate into the Study on Risk Retention a description of the many factors that distinguish auto originations and securitizations from the types of originations and securitizations that gave rise to the inclusion of section 941 in the Dodd-Frank law.

Thank you for the opportunity to comment. Please contact our office if we can provide you with any additional information.

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