

LOAN WORKSHEET #2 – INDIRECT LENDING

Banks purchase consumer installment loans, originated by third parties, to employ excess liquidity, improve overall loan yield, and gain access to a broader customer base. One of the risks associated with the discount of consumer paper arises when a bank fails to **independently** evaluate a borrower’s credit-worthiness, relying instead on the dealer’s representation of the quality of the paper. Unscrupulous or overly aggressive dealers may lull a bank into complacency by front-ending sales with well-documented, acceptable quality paper. However, once the bank relaxes its independent underwriting, the dealer may begin to submit lower quality paper. Frequently, even with good portfolios, the overhead expense of servicing and collecting the portfolio may exceed its income. This is especially true for banks purchasing “Rule of 78” (pre-computed interest) paper. Please note that separate procedures exist for bank purchase of mortgage loans subject to resale (Temporary Mortgage Purchase Programs).

Evaluate	Comments
<p>_____ 1. Does written policy contain the following criteria pertinent to indirect lending?</p> <p style="margin-left: 40px;">A. Down-payment requirements.</p> <p style="margin-left: 40px;">B. Maximum volume by class of paper.</p> <p style="margin-left: 40px;">C. Maximum volume by dealer.</p> <p style="margin-left: 40px;">D. Prohibition on overdrafts in the dealer reserve account.</p> <p style="margin-left: 40px;">E. Bank (vs. dealer) receipt of the borrower’s payments.</p> <p style="margin-left: 40px;">F. Prohibition on the dealer making payments on behalf of the borrower.</p> <p style="margin-left: 40px;">G. Limits on purchasing paper outside of the bank’s normal trade area.</p>	

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<p data-bbox="358 283 802 317">H. Bank verification of sale price.</p> <p data-bbox="358 390 818 527">I. Independent credit-employment checks, or independent verification of the dealer's checks on the borrowers.</p> <p data-bbox="358 604 813 709">J. Written dealers agreements that contain, at a minimum, the following items:</p> <ul data-bbox="407 783 776 1749" style="list-style-type: none"><li data-bbox="407 783 683 852">• List of acceptable collateral.<li data-bbox="407 926 756 995">• Credit requirements for borrowers.<li data-bbox="407 1068 776 1102">• Maximum advance rates.<li data-bbox="407 1176 688 1209">• Repayment terms.<li data-bbox="407 1283 753 1316">• Maximum interest rate.<li data-bbox="407 1390 634 1423">• Discount rate.<li data-bbox="407 1497 769 1566">• Periodic financial statements on the dealer.<li data-bbox="407 1640 769 1749">• Recourse agreement and any recourse reserve requirements.	

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Evaluate	Comments
<ul style="list-style-type: none"> • How the reserve will be used and under what condition the reserve could be transferred back to the dealer. • Extent to which the dealer participates in the collection of accounts, and the capture and disposition of repossessed collateral. • Accident and health, credit life and extended warranty reserves. <p>_____ 2. Select a sample of purchased paper:</p> <p style="padding-left: 40px;">A. Obtain trial balance by dealer (seller).</p> <p style="padding-left: 40px;">B. Obtain a past-due listing and repossession report by dealer.</p> <p style="padding-left: 40px;">C. Select a statistically random sample and review for compliance with policy and credit-worthiness. If significant noncompliance and financial weakness are observed, expand your sample to at least 10% of the indirect paper portfolio.</p>	

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<p>D. Review for compliance with 7 TAC 12.6(h) - Discount of Installment Consumer Paper. In general, this rule requires that balances of purchased paper be aggregated to the selling dealer and subject to the general lending limit (Texas Finance Code Section 34.201) if:</p> <ul style="list-style-type: none"> • The paper carries the dealer’s recourse or guarantee; or, • The bank’s files or knowledge of the financial condition of the maker is not reasonably adequate, and the paper has not been internally certified. <p>_____ 3. Evaluate the financial capacity of the dealers selling to the bank. (While evaluating financial information is important for all types of dealer paper, it is crucial when analyzing dealers that sell that sell paper “with recourse.” In that instance, the bank is relying on the dealer as a secondary source of repayment. Financial information on dealers selling paper without recourse provides insight into changes in financial condition which could affect the quality of the paper sold, or indicate a need to monitor inventory more closely.)</p>	

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Evaluate	Comments
<p>A. Recourse dealers should be evaluated on their capacity to honor repurchase agreements on a significant portion of the discounted paper.</p> <p>B. Non-recourse dealers should be evaluated for deteriorating trends as a precursor of high risk or fraudulent sales contracts.</p> <p>C. If any dealer demonstrates deteriorating or weak financial condition, an additional sample should be taken of that dealer's paper to ensure that standards have not been reduced in order to generate volume.</p>	