Upstart

The new growth opportunity in auto refinance

With over $1.3T in outstanding debt, auto lending is one of the largest consumer lending categories behind mortgages.[1] Despite its large size, banks and credit unions have struggled to build an auto loan portfolio that is both large and profitable. This white paper examines why this is the case and the emerging opportunities for lenders to grow a profitable auto loan program.

Auto lending can be broken down into three broad categories: direct purchase lending, indirect lending, and refinance lending. Each category of lending presents a different set of challenges to lenders.

Indirect lending is the largest category of auto lending with ready-made volume driven by dealers, but is also the least profitable for lenders. High levels of competition for borrowers compresses margins, and few indirect customers ultimately build a larger relationship with the lender. Direct lending can be much more profitable, but is hard to grow. Many consumers do not think to line up financing before they purchase a car, and those who do are often enticed by the dealer to switch to an indirect loan at time of purchase.

Despite the prevalence of mortgage refinancing, few lenders have invested heavily in auto refinancing. Today, refinancing only represents about 5% of auto loan originations.[2] It is often thought to be too difficult and expensive, particularly considering the smaller average loan size. However, new technologies and capabilities have made it possible to build a large, profitable portfolio through refinancing, representing a large opportunity for lenders.

Auto refinance is ripe with opportunity

Several factors make auto refinance an attractive opportunity.

First, auto refinance has the potential to become a substantial part of an auto lending portfolio. TransUnion reported that of consumers who refinanced, 86% saved over $10.[3] This indicates a willingness for consumers to lessen monthly expenses, even if the amount is as low as $10. The report added that many refinanced for less than $30, underscoring these were not edge cases. Upstart recently examined the auto lending market and existing loan volume using sophisticated AI underwriting tools.

We discovered that more than 25% of existing auto loans, or one in four, could be refinanced to save borrowers at least $20 a month.[4] That can translate to an opportunity worth hundreds of billions of dollars in potential lending.

Other factors that also make auto refinance attractive:

No reliance on timing car purchases: There is no need to target consumers who are in the market for an auto purchase, which is difficult to detect. More data is readily available to find consumers who have outstanding auto loans.

Potentially less risk for the lender: Applicants already have a track record of loan repayment.

Build long-term customer relationships: Reducing monthly payments for consumers may help establish trust and retention, providing more cross-sell opportunities.

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Historical barriers preventing auto refinance growth

With so many benefits, why is auto refinance such a small share of most lenders' auto portfolios? Historically, there have been several barriers that have made it challenging for banks and credit unions to take advantage of this opportunity:

High transaction costs: Relative to their loan size, auto refinance loans tend to be expensive to originate for banks and credit unions. This is due to multiple steps required, such as paying off the original loan and working with state and local agencies to transfer the existing lien.

Added burden for consumers: This process may entail making trips to their lender, the DMV, or notary services.

Lack of consumer awareness: Banks and credit unions haven't aggressively explored growing this channel so lenders may not have the experience driving demand through effective marketing.

In addition, the lending experience is of particular importance to younger consumers of Generations Y and Z. These groups are expanding to a larger share of the consumer market as they become more established in their careers, earn more and increase purchasing power. These younger consumers are an informed group with high expectations and traditional auto refinancing at a branch office is less attractive to them. They want the refinancing process to be mobile, digital, and frictionless.

AI paves the way for innovation

A critical technological innovation that has made the auto refinance market more accessible and profitable to lenders is the rise of artificial intelligence (AI). AI can solve several critical challenges that enable banks and credit unions to operate profitable auto refinance programs. Specifically, AI helps:

- Accurately assess and price the risk of borrowers
- Streamline the process to reduce cost and consumer friction
- Target the right consumers to ensure marketing costs are affordable

Refinancing a loan requires an underwriting process that can find pricing inefficiencies missed by the previous lender. In some cases, lower rates can be achieved simply as a result of interest rate changes in the market or a positive improvement in the consumer's credit report. However, traditional credit score-based underwriting models can't effectively go beyond those indicators to individually price consumer risk to uncover inefficiencies.

AI models use much larger data sets and employ sophisticated algorithms to individually price consumer risk, making it easier to offer lower rates safely, without increasing default rates.

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AI underwriting also provides the opportunity for higher automation in the loan origination and onboarding process. Credit decisions can be rendered instantly, and verification can also be performed in a matter of seconds by leveraging the vast amounts of data and algorithms employed by AI. Given the multiple steps and complexity of auto refinance loans, digital automation is critical in meeting consumers' expectations for a fast and simple digital experience.

Used effectively, digital underwriting can eliminate trips to the lender and DMV while reducing paperwork required from borrowers. This also helps banks and credit unions automate and streamline backend processes to reduce origination costs and make auto refinance loans more profitable.

Finally, auto refinancing is a product that few consumers are aware of, requiring lenders to actively solicit consumers who are currently paying too much on their auto loans. AI models can help lenders identify consumers with this latent need among both their existing customer base and consumers in their lending footprint. It enables them to reach the right consumer with the right refinancing offer at the right time.

3 strategies for winning in auto refinance

While the opportunity in auto refinancing is very large, in order to be successful in building a profitable program, banks and credit unions need advanced capabilities in multiple areas. There are three critical components any lender needs in order to build a successful auto refinancing program. Lenders will have to determine which of these capabilities they can build in-house and where it makes sense to find best-in-class partners.

1. MARKET THE OPPORTUNITY

(PRECISE TARGETING)

Auto refinance is a space where you need to know the right channels to leverage and to conduct the right targeting. It's important to effectively find customers who are paying too much interest on their loans and would potentially want to refinance. Lenders should analyze customers' transaction histories for auto loan payments or identify potential candidates from trend lines in credit bureau reports. There are many tactics to consider, but it will be a new muscle to flex for many lenders.

2. MAKE A COMPELLING OFFER

(UNDERWRITING RISK)

As banks and credit unions create demand for auto refinance, they need to offer consumers a compelling savings offer. This is where AI plays a critical role to help lenders accurately price applicants based on their individual risk.

AI can also be highly effective at finding creditworthy applicants in credit tiers just below prime. At Upstart, we believe this is where consumers have often been overpriced due to the lack of sophisticated underwriting methods.[5]

While some institutions may build AI capabilities internally, it makes more sense for lenders to partner with an AI provider from a speed and efficiency standpoint. This also helps avoid the high setup costs of building expertise and technical infrastructure. Lenders should consider AI providers with a track record of success and a large history of training data, which is an important indicator of the accuracy of an AI model.

3. REMOVE BARRIERS FOR CONSUMERS

(DIGITAL PROCESS)

It is imperative to meet the expectations of today's consumer. Providing a fast and simple experience can be achieved with digital technology.

When partnering with an AI provider, it is critical that the technology also includes a great digital experience. Consumers expect to complete loan applications online or from a mobile device.

The digital application itself should be easy to complete, present an instant soft credit decision, and find the vehicle and loan details without requiring applicants to enter their VIN or license plate number. The automated verification process should minimize the number of documents required by applicants while keeping fraud levels low.

An effective AI provider can effectively:

- Handle all the steps required to close the loan
- Pay off the old loan and perfect the lien, according to a state's specific requirements
- Service the loan and offer repossession services

Both applicants and lenders should be relieved of the overhead required to close the loan. This helps ensure a great borrower experience and allows lenders to grow a profitable auto loan portfolio by reducing costs.

Expand your potential for growth

The auto refinance market has historically been a small, unexplored offering for banks and credit unions. However, new market trends and innovations in AI underwriting technology now make it an emerging opportunity to fuel the growth of lenders' auto loan portfolios.

Partnering with an AI underwriting provider can help banks and credit unions get to market quickly by accelerating the deployment of AI technology to more accurately price and predict borrower risk. This enables them to make compelling refinance offers that can save borrowers money while keeping default rates low.

At the same time, AI enables a highly automated digital experience for borrowers that significantly simplifies and automates the application process.

It also helps streamline costs for banks and credit unions. The result is a new channel that can allow banks and credit unions to grow their auto loan portfolio profitably.

If you're interested in learning more about the auto refinance growth opportunity, or would like to speak with our team about how you can leverage Upstart's AI-enabled auto refinancing solution, please email **lenders@upstart.com**.

[1] Household Debt and Credit Report, Federal Reserve Bank of New York, Q4 2020.
[2] Auto refinance: Understanding Consumer Dynamics and how to Capitalize on the Opportunity, TransUnion.
[3] Understanding the Consumer Dynamics of Auto Refinance, TransUnion, Nov. 12, 2020.
[4] This information is estimated based on consumers who qualified for a rate through Upstart. As of 7/1/2021, at least 25% of consumers received a rate that would allow them to save at least $20 a month when refinancing their vehicle.
[5] Based on an internal analysis of Upstart personal loan loss rates across tiers of credit scores below 680.

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