Avoiding compliance “captivity” as a new captive finance company

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Captive automotive finance companies have been a staple of the market in the United States for decades. Traditionally affiliated with long-established manufacturers, these companies have provided support to increase incremental sales through franchise dealer networks and have grown to become some of the most recognized consumer finance brands within and outside the vehicle finance industry.

New entrants have been uncommon, usually following the spinoff or acquisition of automotive brands among existing manufacturing groups. However, with new electric vehicle manufacturers and online dealers seeking to streamline the customer experience through digital, nationwide direct sales, the market is ripe for new players.

Although starting a captive finance company from scratch is theoretically possible, new market entrants usually take one of these approaches:

- Acquiring an existing independent automotive finance company; or
- Creating a passive finance company to accept assignment of contracts, but engaging a servicer to execute all customer-facing activities.

Compliance pitfalls await regardless of the selected path, so plan. Nonbank automotive finance is a creature of state law and requires a complicated licensing analysis. Even when acquiring a robust, existing finance company, state change in control requirements can cause delays. Most states require some form of license or registration to operate as a “sales finance company.” Fewer, but not an insignificant number, require leasing licenses or registrations.

What triggers the license requirement is not consistent from state to state. Some states require a license to accept assignment of retail installment contracts; others require licenses to undertake direct collection of payments or enforce contractual rights against consumers.

Some registrations are effective upon filing while other states have lengthy application examination processes that inquire into all areas of an applicant’s planned activities and will delay even the most diligent applicants. Certain states will take more than a year to approve an application, which can severely hamper operations. Understanding your company’s business model is critical to developing a licensing application strategy that will not unduly delay your business goals.

Leasing companies encounter additional challenges. Although state laws governing vehicle leasing are much less common than those governing retail installment sales, finding an existing independent finance company to acquire that has consumer leasing experience is difficult.

While many of these companies are ready to service retail contracts right away, acquiring the right personnel to conduct leasing-specific services is challenging. This includes residual risk management, end-of-term servicing, and completing sales of leased vehicles to lessees who choose to exercise a purchase option. On this last point, leasing companies that are not affiliated with licensed dealers should be aware that selling a leased vehicle to the lessee is not always exempt from state dealer licensing requirements.

Looking beyond state regulatory compliance, new entrants to a market must determine if their business model will trigger the Consumer Financial Protection Bureau’s “larger participant” rule, which grants the bureau supervisory authority over covered entities. Although certain types of dealer-affiliated companies are exempt, affiliates of direct-to-consumer manufacturers are unlikely to qualify for the exemption.

Companies that fall under the bureau’s supervisory authority face additional responsibilities — particularly in vendor management and developing a robust compliance management system that accounts for all aspects of the consumer relationship. Having these compliance management systems in place at launch is critical to success.

Companies acquiring an existing finance company should also consider if the target will continue its existing independent business in any form and whether the bureau has any history of enforcement activity against that company that could be damaging to the acquiring entity’s brand.

Captive relationships also present opportunities for data aggregation that can be used to offer more attractive options to consumers. However, manufacturers, dealers, and financial institutions may collect vastly different types of data, which is intended to be used for different purposes and which is subject to different privacy laws.

Financial institutions that comply with the federal Gramm-Leach-Bliley Act may enjoy exemptions to various state privacy laws, but those exemptions will not always apply to their affiliates that are not also financial institutions. Organizations must understand how these different laws, which apply to different types of consumer data, will impact the organization’s overall data privacy and security program.

Finally, compliance requirements are not limited to consumer finance issues. States are moving toward new licensing and disclosure requirements for commercial lenders. Although floorplan lines and other types of commercial loan products offered to dealers have generally been exempt, it is not certain that those exemptions will be consistent in every state that chooses to adopt them.

Overall, while it is tempting to consider the captive finance company as just another appendage of the larger sales and distribution model, successful companies understand that “captive” is a bit of a misnomer. The finance company will be subject to compliance requirements to which no parent company will want to subject themselves. Treating the captive as a cooperative, friendly business partner is the path to success.

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