INFORMED

Auto Loan Defect Survey Report

March 2023

Introduction & Purpose

Regulators and legislators continue to introduce new laws or enforce existing ones that leverage interpretations and place administrative pressure on auto lenders and their compliance teams. Many lenders remain susceptible to fines and penalties that are detrimental to their operations and bottom lines.

Auto lenders can more stringently mitigate these scenarios through the implementation of AI-powered systemic controls that help them avoid this additional scrutiny and audit environment. Today, the vast majority of lenders do not have these systemic controls in place to audit the contents of contracts and deal jackets. However, lenders are looking at implementing these controls either through added in-house staff, which is difficult in today's tight labor market; relying on existing manual controls, which are susceptible to human oversight or errors; or through external vendor partners who provide artificial intelligence-based software-as-a-service solutions to automate much of the process.

In addition to providing real-time, no-touch loan processing capabilities, today's AI-powered software enables lenders to comply with regulatory requirements and be audit-ready. The solutions offer policies that are clear and standardized, and lenders are guided through model governance compliance for internal audits while providing expert advice and sample documentation, if necessary.

The following perspectives of auto lenders and auto finance providers can help identify, improve and shape new approaches of the loan origination and securitization process within the auto finance industry. We sought to identify areas where current loan origination challenges, documentation, and procedural defect mitigation merit improvement.

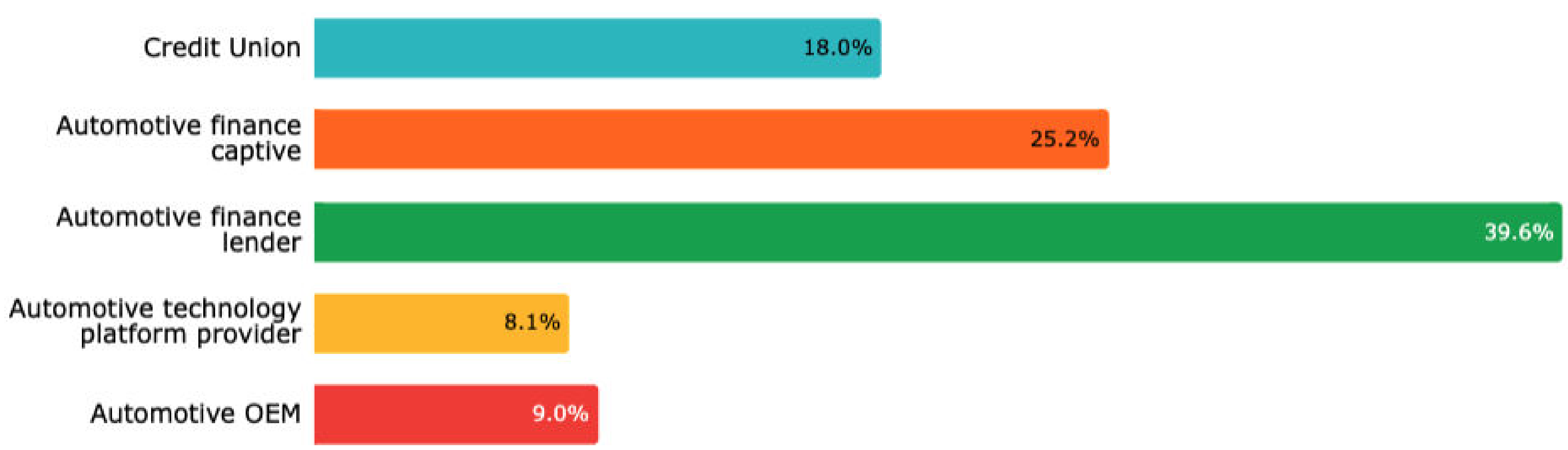
Methodology

The 2023 Auto Loan Defect Survey was conducted online and commissioned by Informed.IQ. Data collected from the survey is used to better understand the current landscape, challenges, and opportunities surrounding automotive lenders and how they track and rectify loan documentation inaccuracies.

The target population of the 2023 Loan Defect Survey includes executives and key decision makers who currently work for a variety of automotive lenders and loan servicers throughout the U.S. The online survey was administered during the first two weeks of March 2023 and was presented to more than 2,500 professionals during this time.

Demographics

The survey responses explored in this report come directly from working auto finance professionals currently holding positions in the below types of lenders and organizations.



Executive Summary

Chat GPT has taken the internet by storm, once again placing AI technology front and center in people's minds. And while it is fascinating, Chat GPT has a ways to go before becoming a truly valuable business tool. AI software applications, however, have been around for nearly 40 years, providing specialized machine learning models with enough time to train and become indispensable in certain industries, especially financial services.

A recent PWC survey (1) on AI found that 52% of companies accelerated their AI adoption plans in the last year, while IDC forecasts worldwide spending on AI is expected to surpass $300 billion by 2026. (2)

Financial Institutions and Auto Lenders have been leveraging AI software to make their operations "smarter," cheaper and faster for the last decade, uncovering countless benefits including:

- **Increase Capture:** Funding dealers faster increases look-to-book. Dealers do more business with lenders who pay them the fastest and minimize contracts-in-transit / unwinds.
- **Reduce Fraud:** Avoid charge-offs by catching falsified income and other misrepresentations. Automate second-line risk controls to better comply with policies and procedures.
- **Dealer Rewards:** Dynamically stip dealers based on their rate of fraud, defects, and misrepresentations. Streamline and speed-up the process of capturing loans from compliant dealers.
- **Reduce Friction:** Identifying defects early in the process reduces Contracts in Transit.
- **Free Up Staff:** Scale originations at busy times (i.e. tax season) without adding more headcount. Focus staff on deepening relationships with dealers to capture more loans and borrowers to increase Net Promoter Scores.

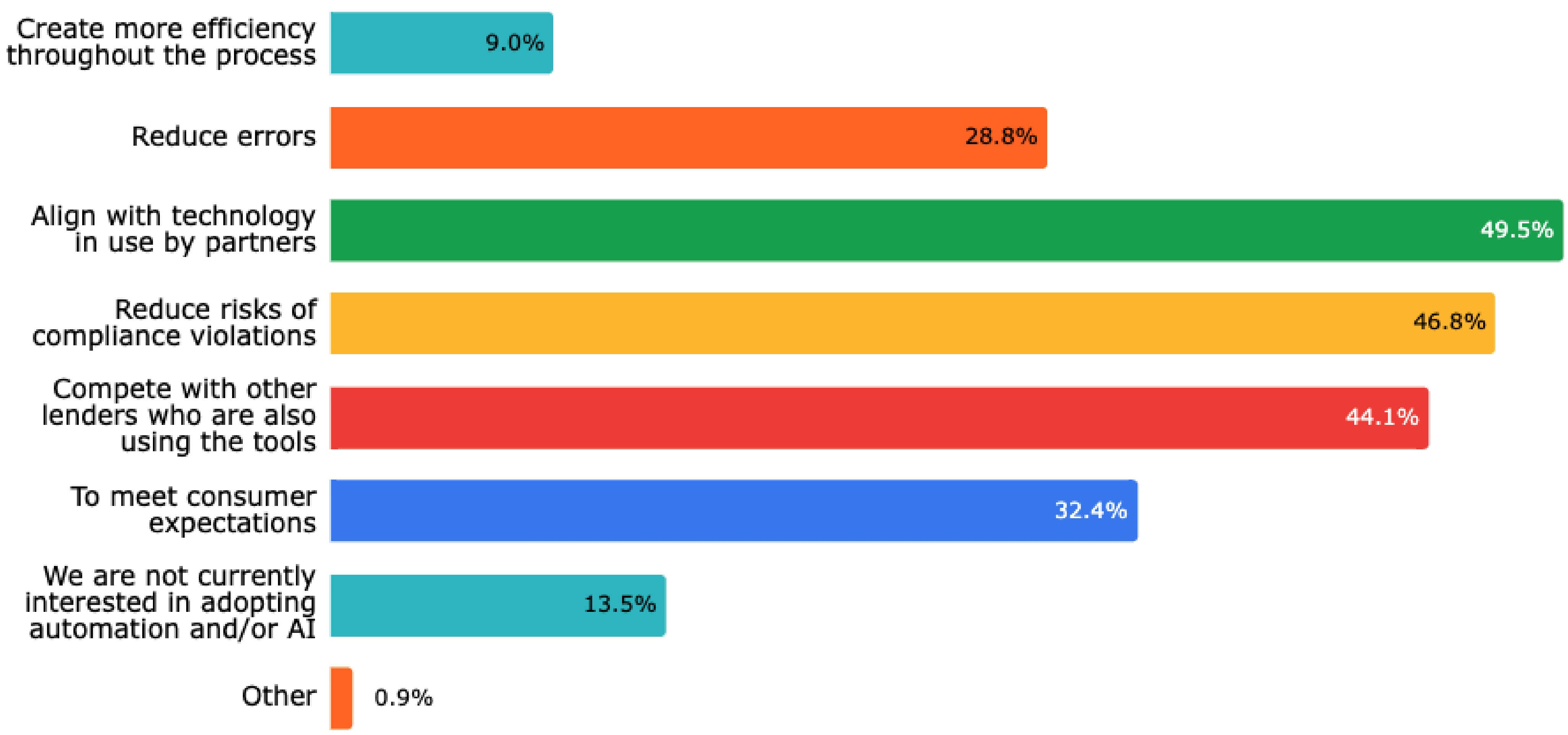
And there's another benefit which merits more discussion and that is Regulatory Compliance. In this heightened regulatory environment auto lenders must be mindful of CFPB and FTC actions, and comply with Dodd-Frank, ECOA, Fair Lending and other regulations. AI Automation is a valuable tool for lending staff to leverage as they look to reduce bias and fraud, comply with regulations and stay on the right side of auditors and regulators.

Bringing AI into the auto lending process is just one way that lenders stay competitive, profitable and compliant with regulations.

(1) *PwC 2022 AI Business Survey* https://www.pwc.com/us/en/tech-effect/ai-analytics/ai-business-survey.html
(2) *Fast Company* https://www.fastcompany.com/90868225/how-to-be-a-leader-in-an-ai-powered-world#

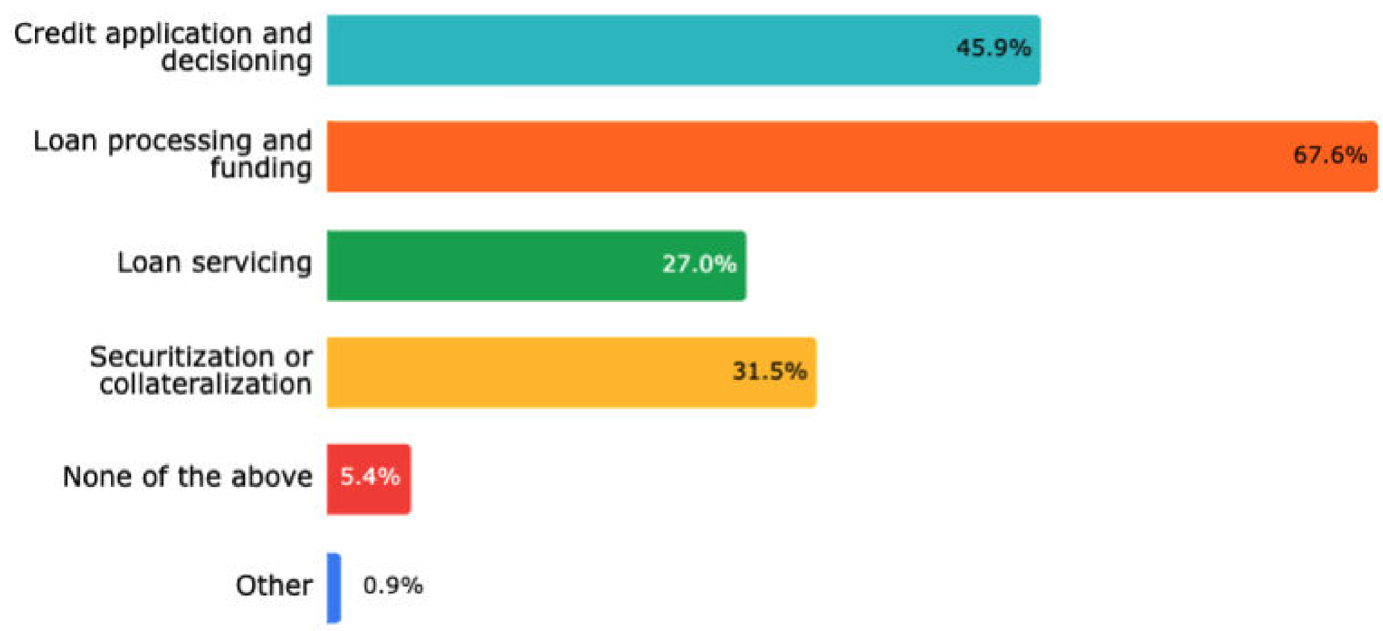
Report Highlights

- 95% of lenders are beginning to leverage AI tools in some aspect of their business (i.e. credit decisioning, loan servicing)
- 51% of lenders cited regulatory audits as their biggest concern
- 30% of lenders said the top metric automation has improved in the lending process is reduced cost
- Nearly 44% of lenders (see chart below) are interested in leveraging AI to compete with lenders who are also using these tools



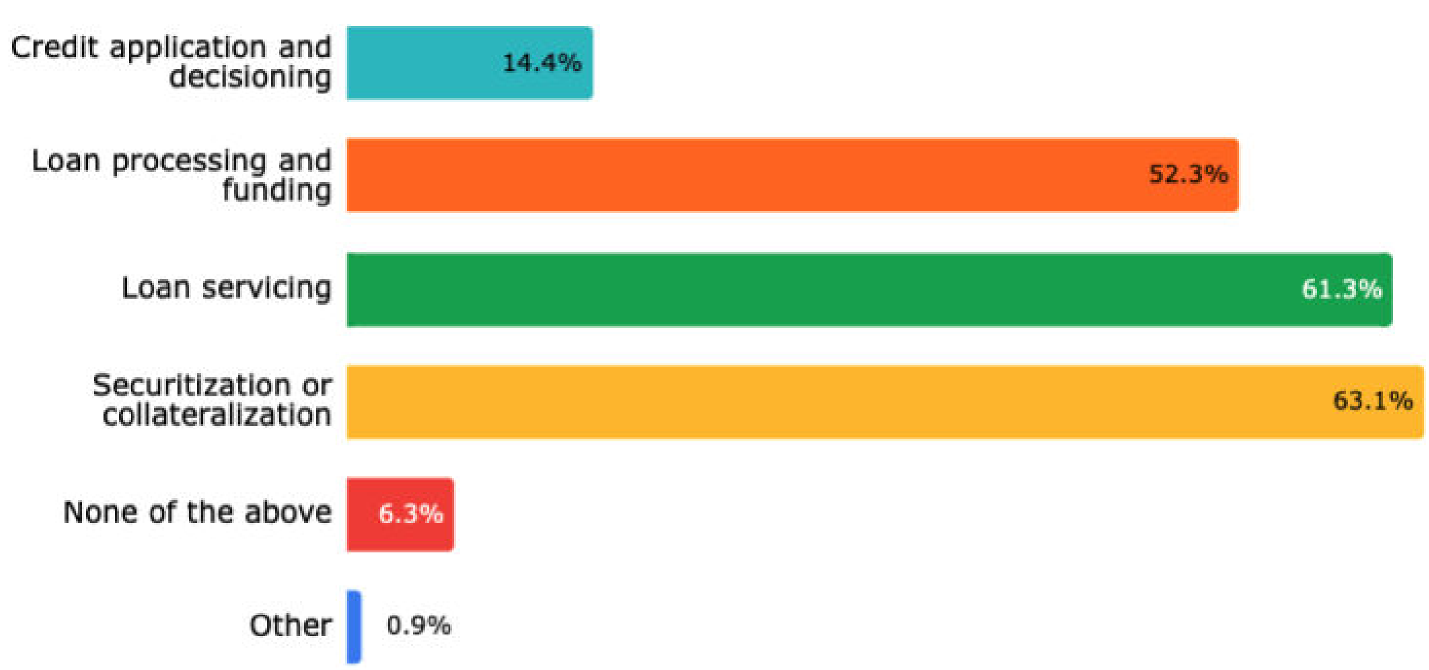
In which of the following processes did you leverage automation last year? What's next?

When lenders were asked where they'd employed automation over the last year, most respondents, 68%, cited loan processing and funding, with credit application and decisioning coming in second with 46%. This indicates that the investment in automation was largely in support of improving margins by streamlining "back office" repetitive tasks associated with the lending process.



Looking ahead through 2023, most lenders are eyeing automating their securitization business - 63%, followed by loan servicing at 61%, and loan processing and funding at 52%. Taking both years together, the data shows that loan processing is the most accepted place for automation. All of these processes are extremely document heavy, requiring lots of time spent "staring and comparing" to ensure the data match. That type of work is well suited to automation since there is not a lot of room for judgment calls – i.e., do the dates match or not?

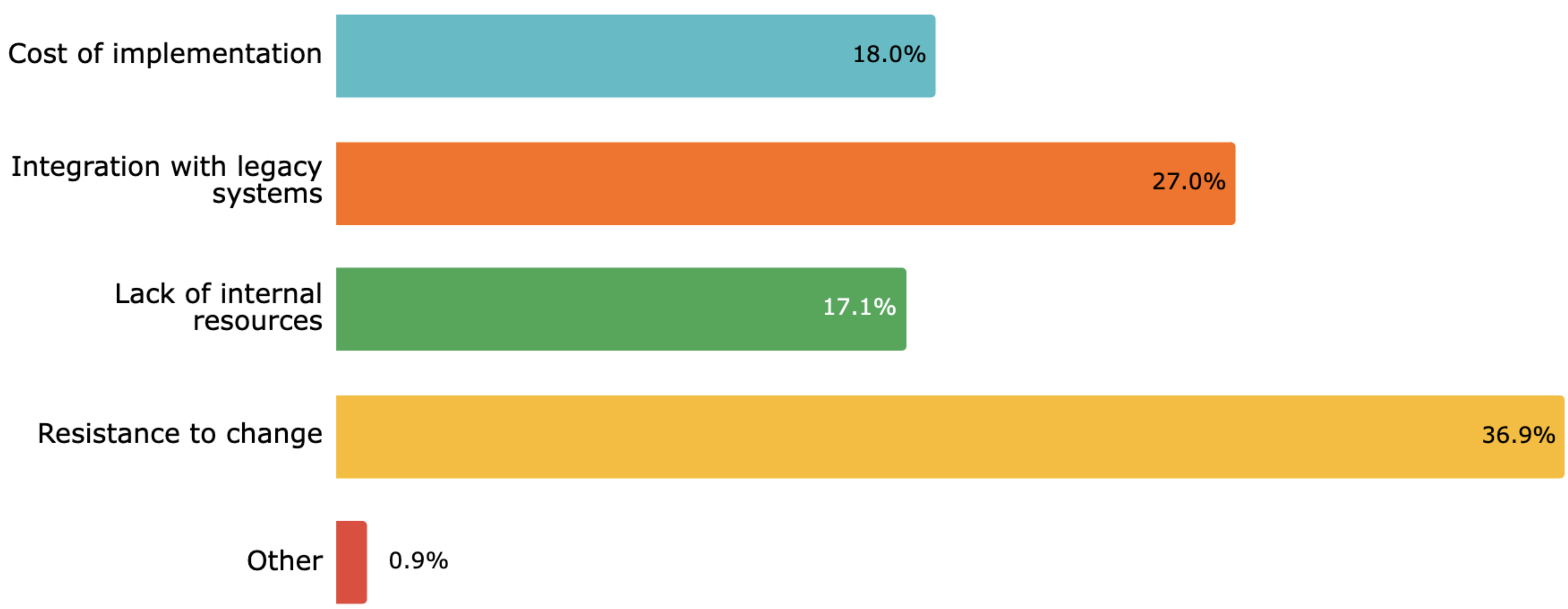
Unlike repetitive tasks, actual lending decisions involve complex assessments of a borrower's creditworthiness, including factors such as their income, employment history, credit score, and debt-to-income ratio, so those decisions are best left to humans.



What are the biggest challenges you have faced in implementing automation in your lending business?

It is not surprising that the biggest hindrance to leveraging AI technology at lenders is resistance to change at 37%. Change management requires planning, expertise and resources. AI companies need to possess strong credibility and an intimate understanding of their clients' businesses and needs, and operational requirements to successfully partner.

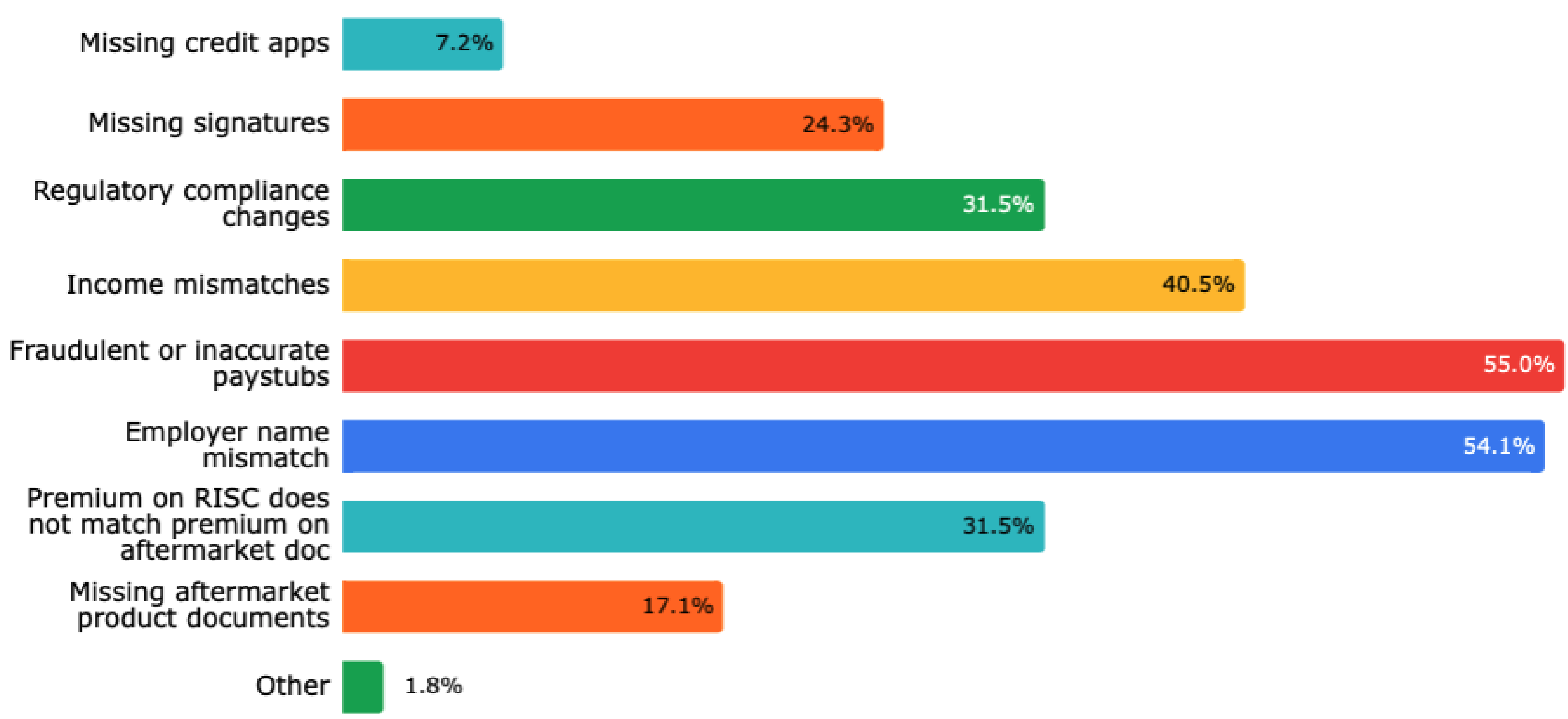
This data also indicates that the lift to move off of old systems is likely impaired by availability of resources and therefore a push back on making changes to existing systems. That's why asking the important questions is essential when choosing an automation partner. Consider questions such as: Do you have professional services or customer success people to help? How complex is the integration with our in-house systems? And, what changes to our processes and systems is required?



Where do you see the biggest challenges when it comes to documentation defects?

Fraud rates are rising along with increased use of digital tools. And fraud was the number 1 challenge cited when it comes to documentation defects according to 55% of respondents. Closely behind at 54% was "employer name mismatch," one of the easiest defects to remediate with properly trained AI/ML solutions.

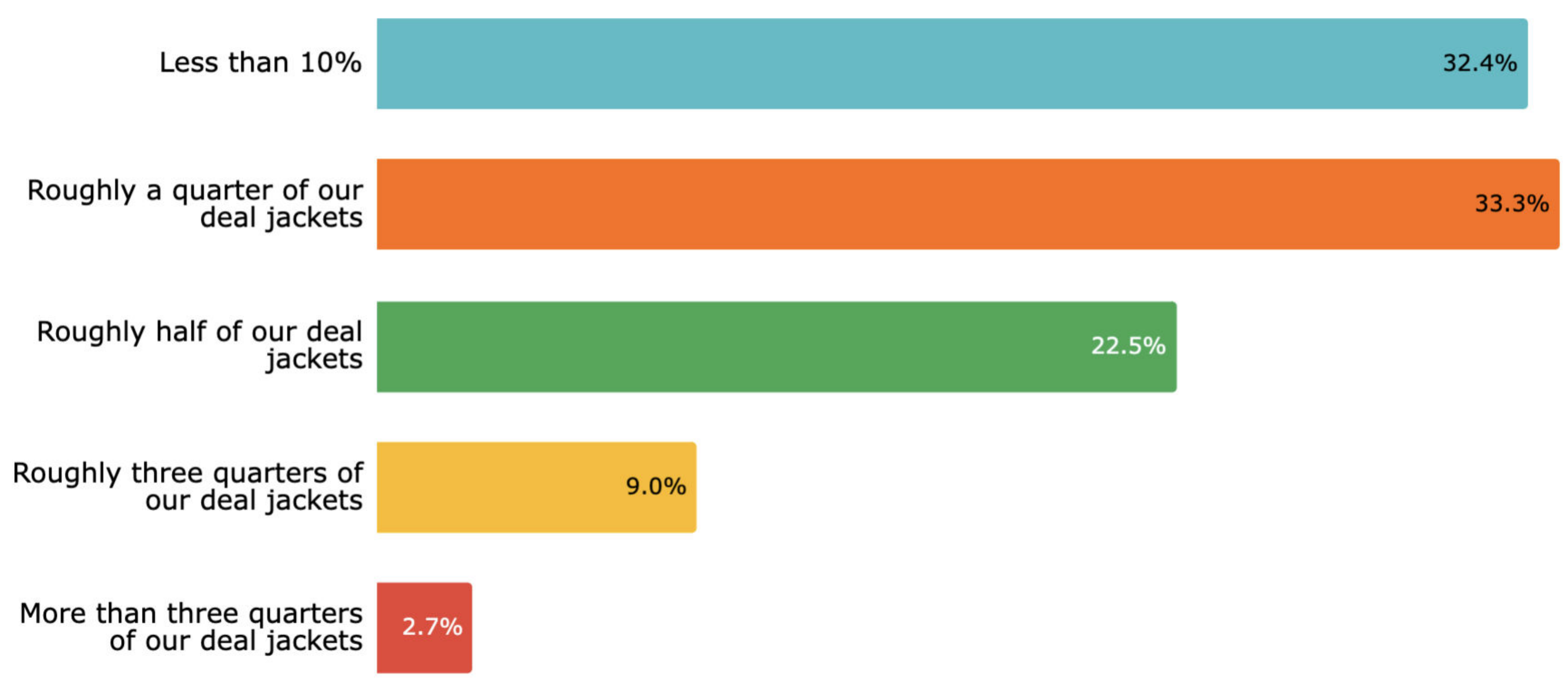
To prevent fraud in auto lending, lenders can implement strong fraud detection and prevention processes, including verifying borrower information, conducting background checks on dealerships, and monitoring loan performance. It is also important for lenders to provide fraud prevention education and training to employees to help them identify and prevent fraudulent activities.



Can you estimate how many deal jackets in your portfolio had defects in 2022 from any of the previous question's options?

About 66% of respondents reported that 25% or less of their deal jackets had defects in 2022, yet those defects cost between $1M and $5M in associated costs. Auto lenders can more stringently mitigate defect scenarios by implementing AI-powered systemic controls that help them avoid audits. Today, the vast majority of lenders do not have systemic controls in place to audit the contents of contracts and deal jackets.

However, lenders are looking at implementing these controls either through added in-house staff, which is difficult in today's tight labor market; relying on existing manual controls, which are susceptible to human oversight or errors; or through external vendor partners who provide AI-based software-as-a-service solutions to automate much of the process.



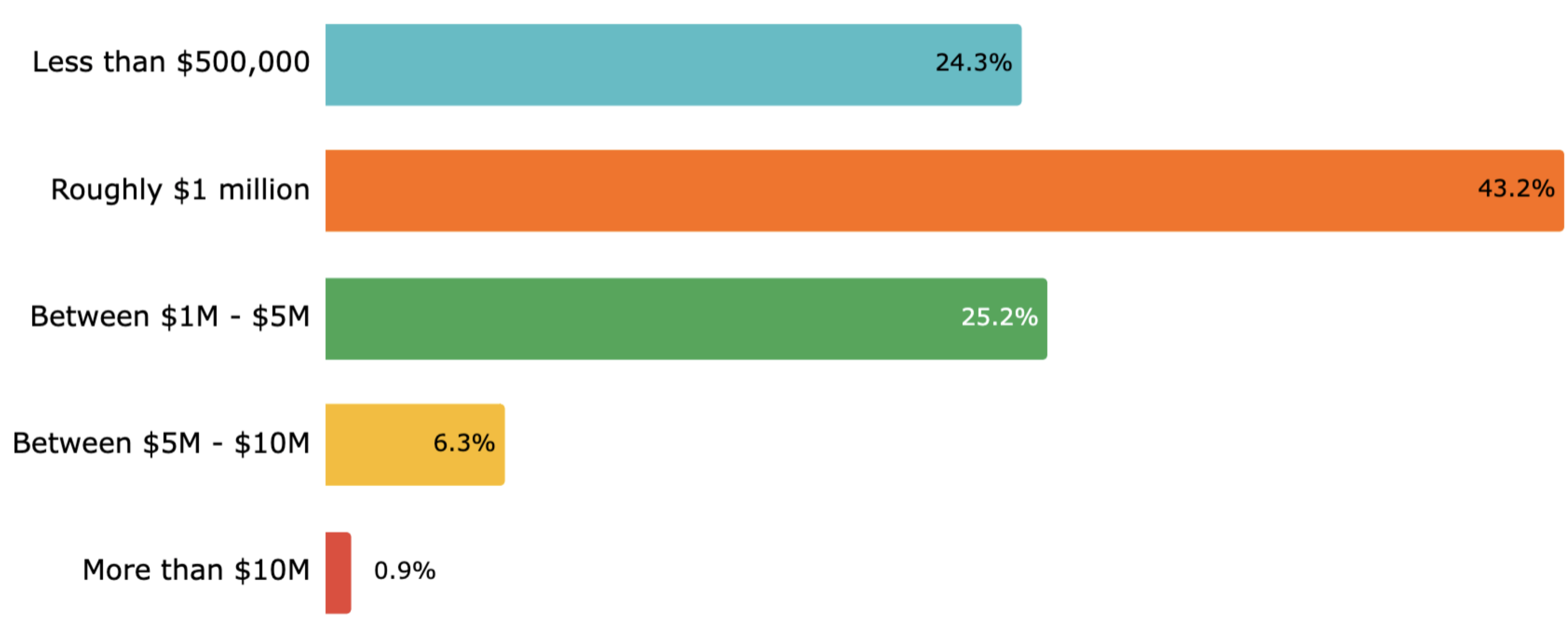
Can you estimate how much the errors in your deal jackets cost you in 2022 (costs associated with repairs, lost deals, etc.)?

According to the survey findings, nearly half of respondents (43%) said deal jacket errors cost them approximately $1 million during 2022. And 76% of lenders estimate deal jacket defects cost them $1M or more - yet only 2.7% are "very satisfied" with current levels of automation in their business (see page 18). This may illustrate that a lack of AI solutions is creating significant costs for lenders, or that existing solutions historically have not adequately addressed these issues.

Errors in deal jackets can be very costly to auto lenders, in terms of financial losses, damage to their reputation and regulatory compliance findings. If there are errors in the deal jacket, it can lead to issues such as incorrect loan amounts, interest rates, or payment terms. These errors can result in financial losses for the lender, such as missed payments, defaulted loans, or legal disputes with borrowers.

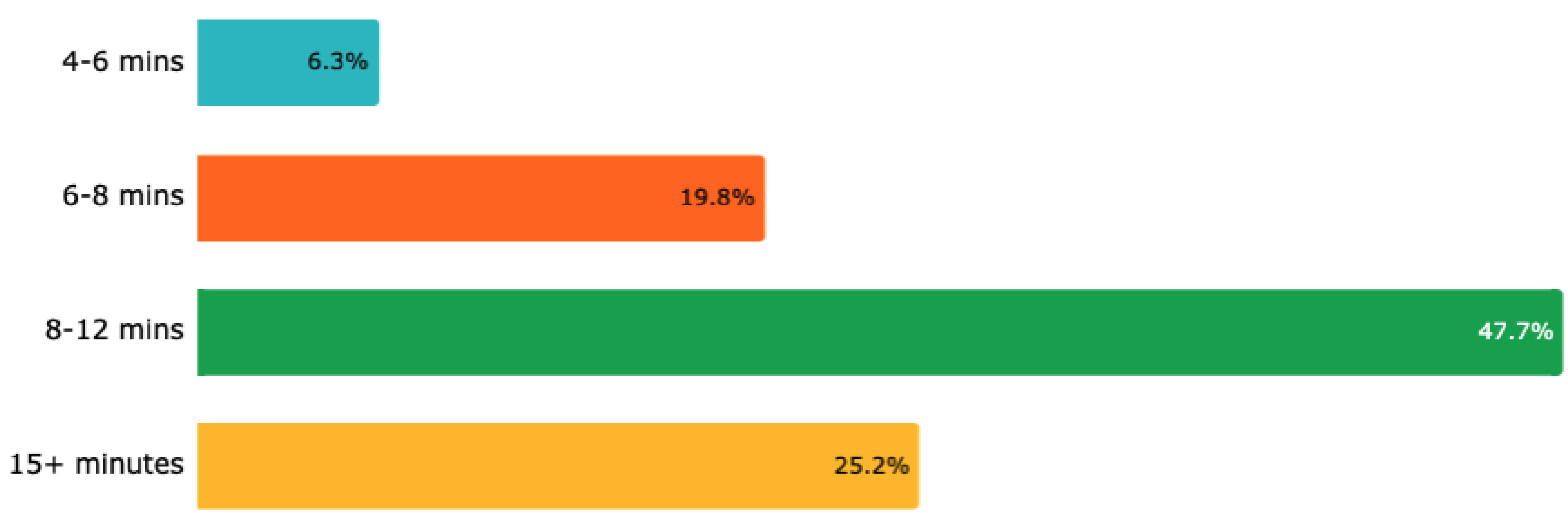
In addition to the financial costs, errors in deal jackets also damage a lender's reputation. If borrowers become aware of errors or discrepancies in their loan documents, they may lose trust in the lender and take their business elsewhere. This can lead to a loss of revenue and market share for the lender.

To minimize the risk of errors in deal jackets, auto lenders should have strong quality control processes in place. This may include having multiple layers of review and verification, conducting regular audits of loan documents, and using automated tools to identify potential errors or discrepancies. Without automated tools, these functions are time-intensive and costly. Reducing defects up front reduces costs.



How long does it take to remediate and manually onboard a deal jacket?

The majority of lenders surveyed said they typically average between eight and twelve minutes to remediate a deal jacket and then manually onboard it – precious time that adds up when considering thousands of loans in a portfolio. 93% of respondents reported that it takes 6+ minutes to remediate a deal jacket and manually onboard it. This is important given AI solutions' typical SLA of 5 minutes. And that it actually identify defects on behalf of the lender, further providing specific proof that technology can be leveraged to automate manual onboarding/ funding processes.



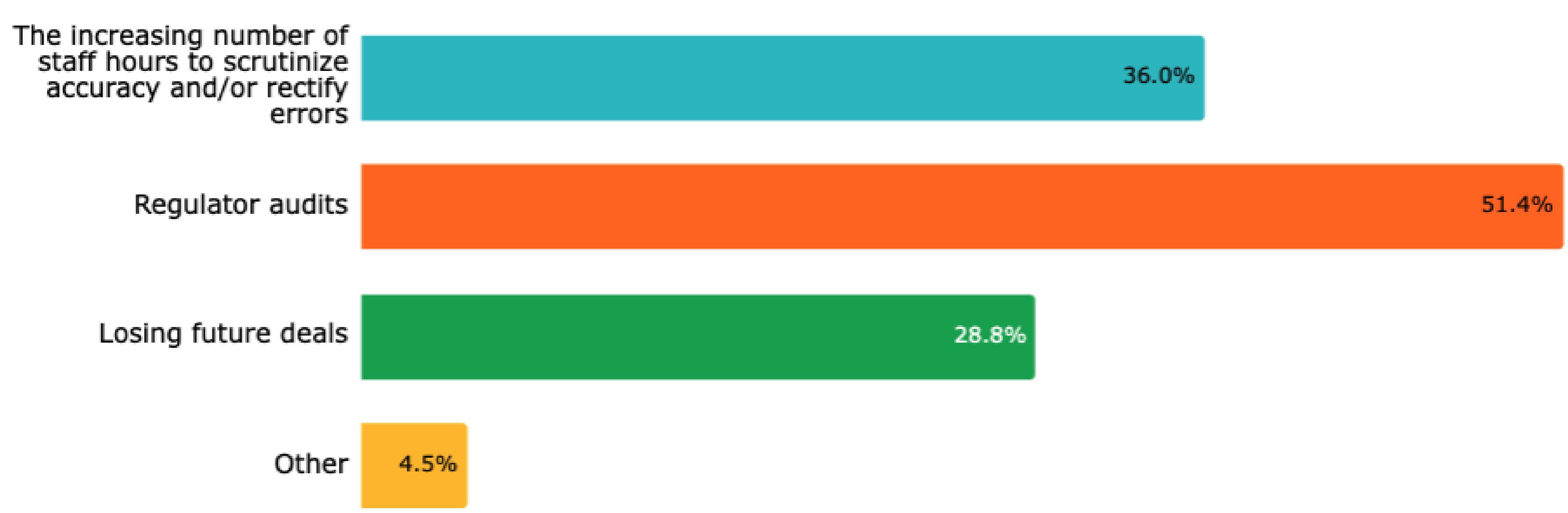
When it comes to the accuracy of your deal jackets, what are you most concerned with in 2023?

Regulator Audits are top of mind when considering accuracy of deal jackets for auto lenders - in fact, 51% of lenders cited regulator audits as their biggest concern. Technology can help streamline these audits and bolster compliance through programmatic and documented controls in an ever-evolving regulatory environment.

Audits require a significant amount of time, resources, and preparation. They are conducted by regulatory agencies to ensure that lenders are complying with relevant laws and regulations, such as the Fair Credit Reporting Act (FCRA), the Equal Credit Opportunity Act (ECOA), and the Truth in Lending Act (TILA).

Audits typically involve a thorough review of the lender's policies, procedures, and practices related to lending, as well as a review of loan files and other documents. The regulator may also conduct interviews with key personnel and request additional documentation as needed.

The process of preparing for an audit can be time-consuming and stressful for lenders, as they must ensure that all relevant policies and procedures are up-to-date and in compliance with regulations. This may require significant changes to existing processes and documentation, as well as the implementation of new controls and systems to address any regulatory findings. Having the right technology in place streamlines the audit process since there is a thorough record of the processes in question.

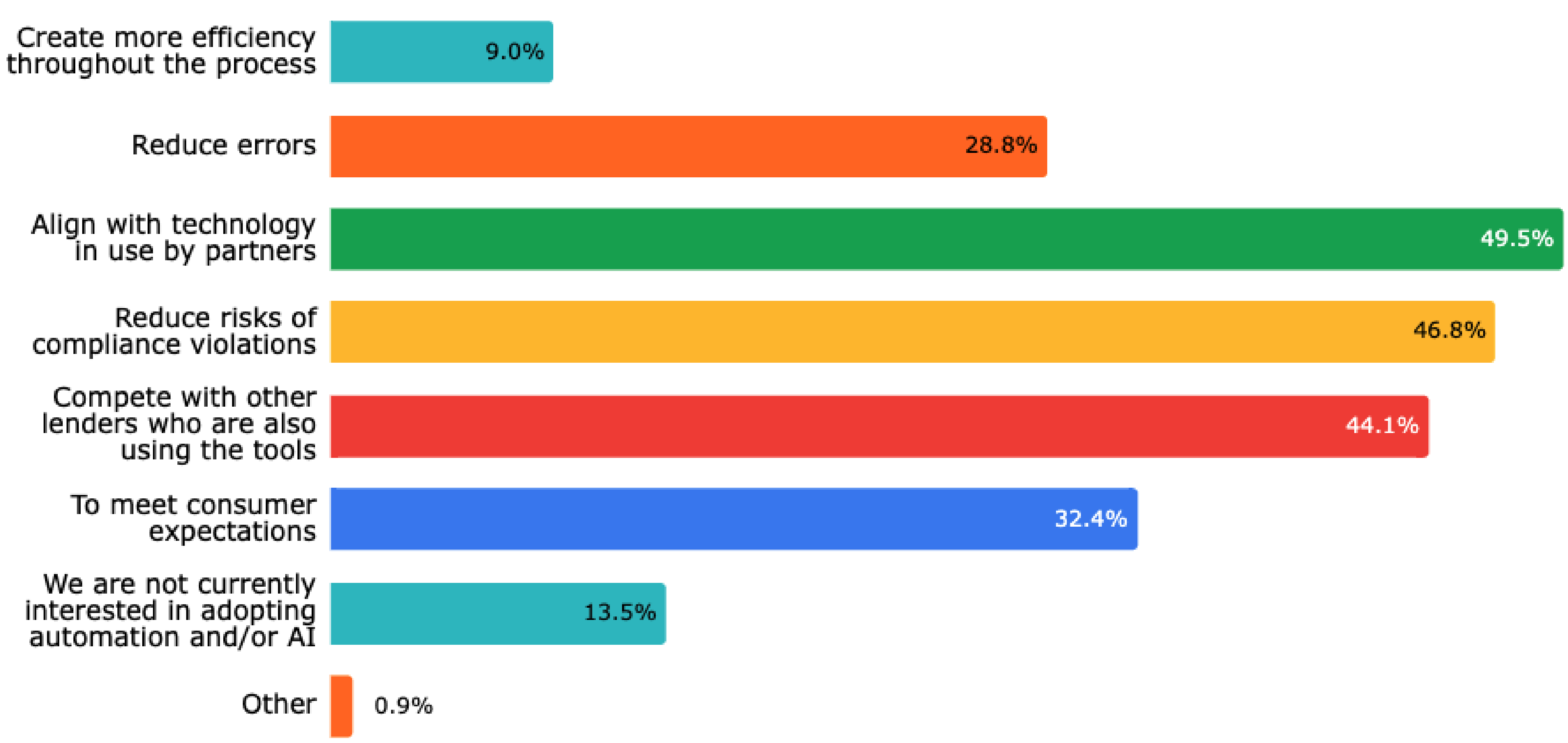


What are the reasons you want to adopt more automation and/or AI tools for your deal jackets?

Nearly 44% of lenders are interested in leveraging AI to compete with lenders who are using these tools and 50% do so to align with their partners, further highlighting that lenders are influenced by those around them. AI technology will change the market, increase speed, and decrease the cost of doing business. And lenders are concerned they will not be able to keep up with competitors using the technology. Once they see others around them using AI technologies, it will have a massive influence on the market as lenders feel they are being left behind.

Reducing risk of compliance violations (47%) outweighs creating efficiency (9%) and reducing errors (29%) combined. However, when asked how they measure success, reducing error rate was the number one response.

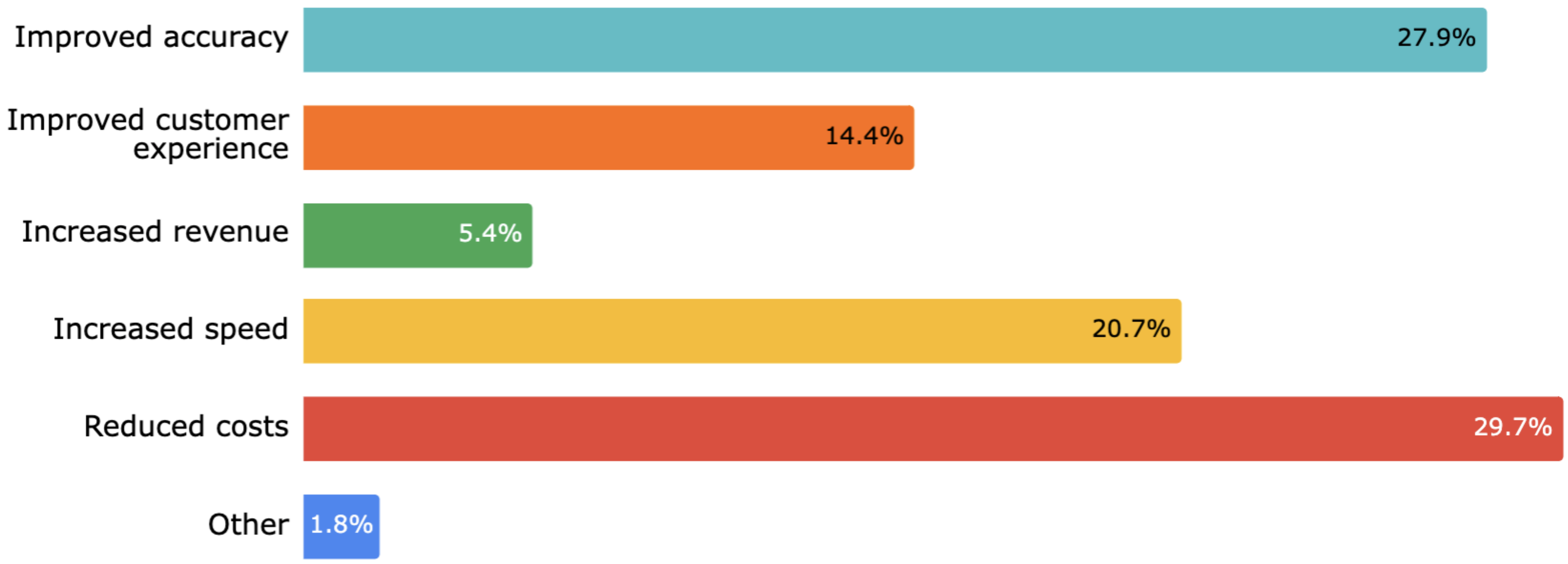
This would indicate the current regulatory environment is driving a large portion of decision making but the key criteria for buying is error reduction.



How has automation improved your lending process?

The top response for how automation has improved the lending process is reduced costs. Coupled with the top response for how success is measured, reduced error rates which cost lenders between $1M and $5M yearly, shows that ROI is top of mind in any automation project.

Reduced costs and improved accuracy are the value propositions of almost every type of automation solution. This indicates just how much lenders have to gain by implementing some level of automation in their lending processes. Lenders are often happily surprised by the high levels of accuracy that automation brings and finds the technology to be more accurate than humans.

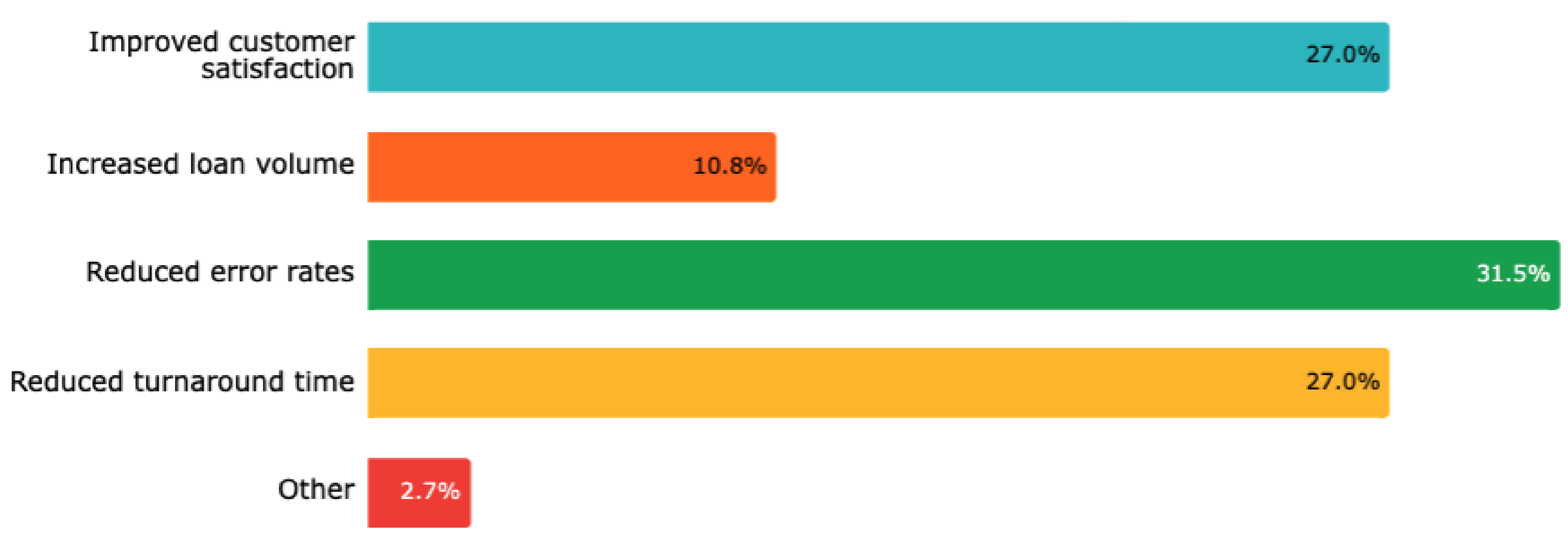


How do you measure the success of automation in your lending business?

There are several ways to measure the success of automation in your lending business:

1. Reduced Error Rates 32%
2. Reduced Turnaround Times 27%
3. Improved Customer Experience 27%
4. Increased Loan Volume 11%

By measuring these key performance indicators, lenders gain insight into the success of automation in their lending business and identify areas for further improvement. Aligning structured, measurable KPIs and goals ensures that AI projects are set up for success and delivered to the lender's expectations.



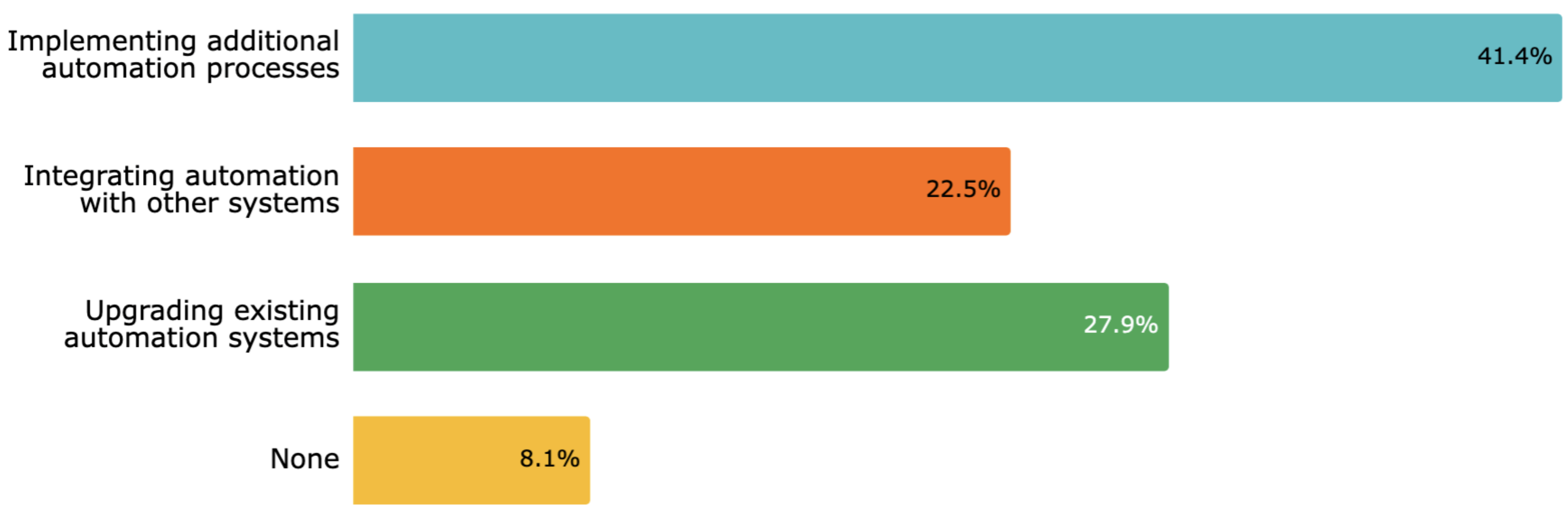
What are your future plans for automation in your lending business?

Lenders are increasingly planning to invest in automation to improve their lending processes (41%).

According to a survey conducted by the Federal Reserve Bank of New York in 2021 (3), the majority of lenders reported that they were planning to invest in automation in the near future. Specifically, 87% of lenders indicated that they were planning to invest in automation to improve their underwriting processes, while 69% planned to invest in automation to improve their loan origination processes.

Lately, leveraging AI automation in underwriting has been elevated in focus as lenders look to increase transparency and reduce bias in the decisioning and underwriting processes.

Overall, lenders are increasingly recognizing the benefits of automation in improving the efficiency, accuracy, and cost-effectiveness of their lending operations. As such, most lenders are planning to invest in automation in the coming years to stay competitive and meet the evolving needs of borrowers. In fact only 8% of survey respondents reported they would not invest in further automation.



(3) *Senior Loan Officer Opinion Survey* https://www.federalreserve.gov/data/sloos/sloos-202110.htm

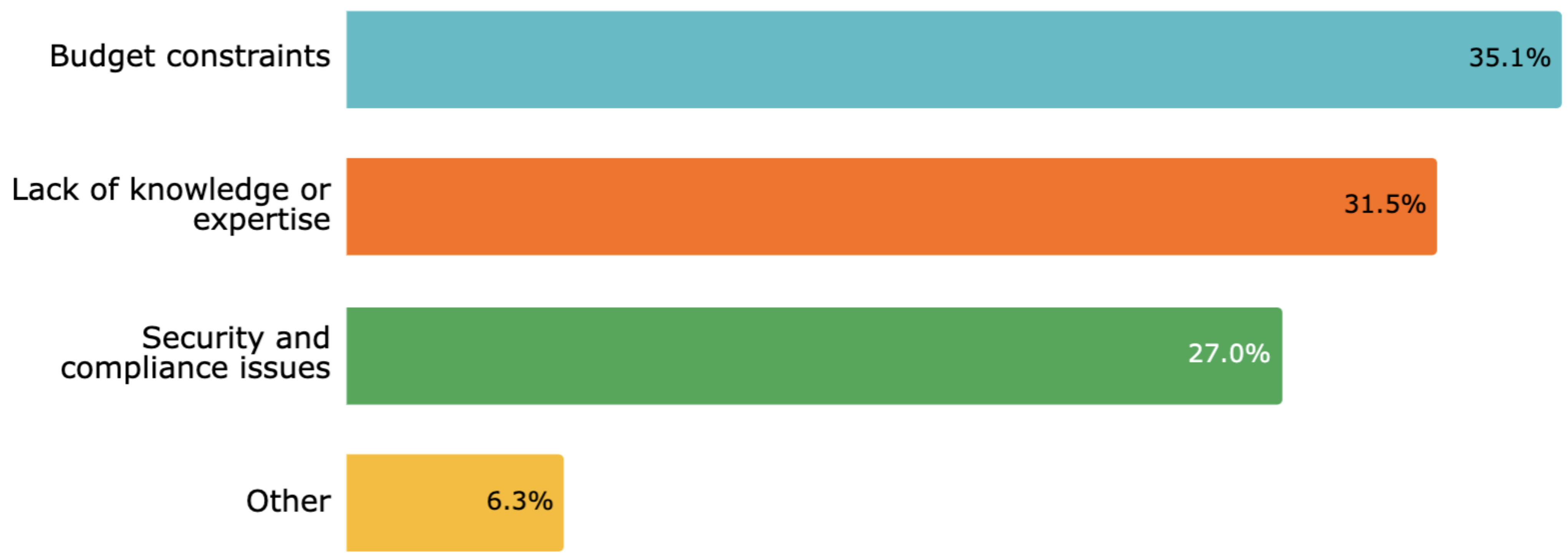
What concerns do you have about implementing additional automation in your lending business?

While lenders recognize the benefits of automation in improving the efficiency, accuracy, and cost-effectiveness of their lending operations, there are also concerns and challenges associated with automation. Here are some of the concerns that lenders may have about automating their lending processes:

1. Cost of Implementation 35%
2. Lack of Internal Expertise 32%
3. Security and Compliance Issues 27%

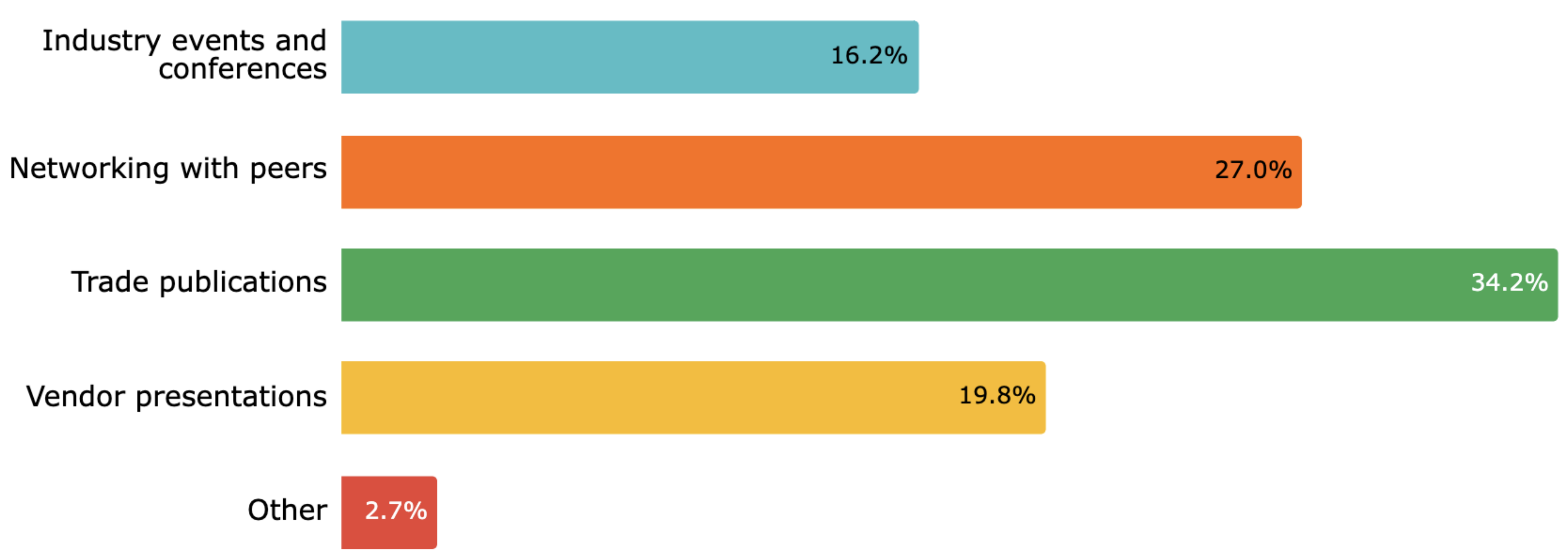
Overall, while automation can bring many benefits to lenders, there are concerns that must be addressed to ensure successful implementation and ongoing operations. Lenders need to carefully consider these concerns and develop strategies to mitigate them as they plan for automation in their lending operations. Ensuring that new systems integrate seamlessly with existing systems should be a "must have" when choosing an automation partner.

It is important to choose a technical partner with deep subject matter experience in a lender's specific segment, with staff focused on continuous improvement, to ensure long term success.



How do you stay informed about the latest automation trends and technologies?

Between the rise of "online self service" and the recent pandemic, the ways in which people get their information has changed. Prior to 2020, conferences and industry events had been the number one way people reported getting peer recommendations. But with a two year pause in many events, trade publications now tops the list at 34% with only 16% citing industry events. The rise in virtual events may account for networking with peers coming in second at 27%. Not that so many in-person (or IRL) events are back, it will be interesting to see how this trend holds up.



How satisfied are you with your current automation systems?

When asked how satisfied they are with their current level of automation, 54% of respondents were 'neutral' in their satisfaction with current automation systems. Automation is still new for many lenders and introducing multiple vendors makes integration difficult and causes disruption. It's important that automation solutions are as seamless as possible with straightforward integrations and strong partner support.

There are several ways to measure the success of automation:

1. Efficiency gains
2. Cost savings
3. Quality improvements
4. Compliance

By measuring these key performance indicators, lenders can gain insights into the success of automation in their lending business and identify areas for further improvement.

Conclusion and Next Steps

AI technology will increase speed, decrease the cost of doing business, lower risk and make lenders more profitable. Automation improves the lending process in several ways:

- **Faster processing times:** Automated systems process loan applications more quickly than manual processes. This helps lenders make lending decisions more efficiently, reducing the time it takes to approve loans and disburse funds.

- **Improved accuracy:** Automated systems help reduce errors and inaccuracies in the lending process.

- **Reduced costs:** Automated systems reduce costs in the lending process by eliminating the need for manual processes and reducing the risk of errors and inaccuracies. This helps lenders lower their operational costs and offer more competitive interest rates to borrowers.

- **Enhanced risk management:** Automated systems help lenders better manage their lending risks by providing real-time data and analytics on borrower behavior and loan performance. This enables lenders to identify and mitigate potential risks, such as defaults or delinquencies, more quickly.

- **Improved customer experience:** Automated systems improve the overall customer experience by providing faster processing times and more personalized lending decisions. This enables lenders to build stronger relationships with their customers, increase customer loyalty and Net Promoter Scores.

- **Return on investment (ROI):** Finally, measuring the ROI of automation investments is another important way to assess the success of automation in your lending business. This could include metrics such as the net present value of automation investments or the payback period of automation projects.

Overall, automation streamlines and improves the lending process in a variety of ways, making it more efficient, accurate, and cost-effective for lenders and borrowers alike.

So what can you learn from this data to inform your automation journey? Do the results provide any insights into how you should think about how and where to use automation in your lending process?

Here are some key questions to consider as you weigh your options:

1. Do you have a high number of low-level, repetitive tasks that could be automated, such as signature matching, date checking, and are all documents accounted for in the deal jackets?
2. Are your employees expressing job dissatisfaction or are you experiencing high turnover?
3. Can you appropriately scale up and down throughout the year?
4. Are you satisfied with your capture rates and dealer satisfaction scores?

It's clear that some level of automation is critical to staying competitive. And in this challenging and changing economic climate, "doing more with less" will continue to be a reality.

About Informed.IQ

Informed uses AI and ML to instantly verify income, assets, residence, insurance, auto stipulations, credit stipulations and more; enabling real-time, reliable credit decisions without bias. Informed's ML models are trained to process hundreds of document types and consumer-permissioned data sources, automating stipulation clearance for lenders. In 2022, Informed processed over 4 million consumer credit applications for major US lenders, automating over $110 billion in loan originations to date. In 2023 the company expects to see 40% of US auto loans.

Informed automates verifications in seconds with no humans-in-the-loop. Originally the company focused on auto lending, where seven of the top ten auto lenders now use the solution. Financial institutions also use Informed for mortgages, credit cards, personal and student loans, and automated bank account openings.

Founded in 2016, Informed.IQ raised $20M in 2021 from notable investors including Nyca Partners and US Venture Partners.

To learn more, visit **informediq.com** or follow Informed on **LinkedIn**.

Would you like to see the ROI you can expect when implementing automation?

See Your ROI