Ebook

October 2022

From Afterthought to Strategic Approach:

Managing Ancillary Product Refunds

Facilitating the lifecycle of ancillary products like GAP and VSC/extended warranties can be challenging and financial institutions are facing increased regulatory pressure for calculating and issuing product refunds to consumers. Establishing an ancillary product refund process both prioritizes and protects consumers, while reducing your institution's risk. Learn how to leverage a proactive approach to the changing regulations to enhance compliance and mitigate risk on product refund liability.

Table of Contents

Introduction

Financial institutions are looking for opportunities to enhance the auto loan servicing experience for their consumers. At the same time, consumers are looking for ways to increase the value of their vehicle and extend its life.

While servicing auto loans, financial institutions often facilitate the lifecycle of add-on products consumers purchase at the onset of the auto loan. This becomes more complex with indirect loans. In many cases and for various reasons, these products may require a cancellation of service. When a product is cancelled before the consumer receives the full and original benefits, this poses the question,

"Who is responsible for ensuring the consumer receives a refund?"

According to many state and federal regulations and emerging best practices, financial institutions bear this responsibility. In this eBook, we'll dive into why disregarding the responsibility is no longer an option, and how few lenders have the infrastructure to take on the refund process. It is critical that financial institutions understand how ancillary products play a role in the auto loan process and pay attention to how the regulatory landscape is changing to best adapt and take control of the process. By proactively tackling this issue, financial institutions can strategically anticipate and solve the challenge of managing cancelled ancillary products in a timely, compliant manner.

CHAPTER 1

Defining Ancillary Products and Triggering Events

Facilitating the lifecycle of ancillary products can be challenging, especially as regulations related to ancillary products are ever-changing. This chapter dives into what qualifies as an ancillary product, which types of events trigger an ancillary product to be cancelled, and how this is impacting financial institutions.

What Are Ancillary Products?

Consumers often purchase ancillary products in addition to the auto loan financing, especially as vehicle prices rise. Ancillary products are optional but appealing to consumers. These ancillary products are typically serviced by a third-party vendor or product provider and may be purchased directly through the financial institution or indirectly through a dealer.

Ancillary products may also be known as:

- Vehicle Protection Products (VPP)
- Point of Sale (POS) products
- Aftermarket products
- Aftermarket services
- Extended warranties

Consumers may purchase one or more ancillary products to maintain the longevity of their vehicle, defer financial risk, and protect against environmental incidents.

Types of ancillary products can include:

- GAP (Guaranteed Asset Protection)
- DPW (Debt Protection Waiver)
- Credit Insurance (e.g. Credit Life, Credit Disability, Credit Property, Involuntary Unemployment Insurance)
- Vehicle Service Contracts, such as Tire & Wheel and Mechanical Breakdown Protection such as Extended Warranties, Tire & Wheel, and Mechanical Breakdown Protection Waiver

> ***Consumers may purchase one or more ancillary products to maintain the longevity of their vehicle, defer financial risk, and protect against environmental incidents.***

What Triggers a Cancellation or Refund?

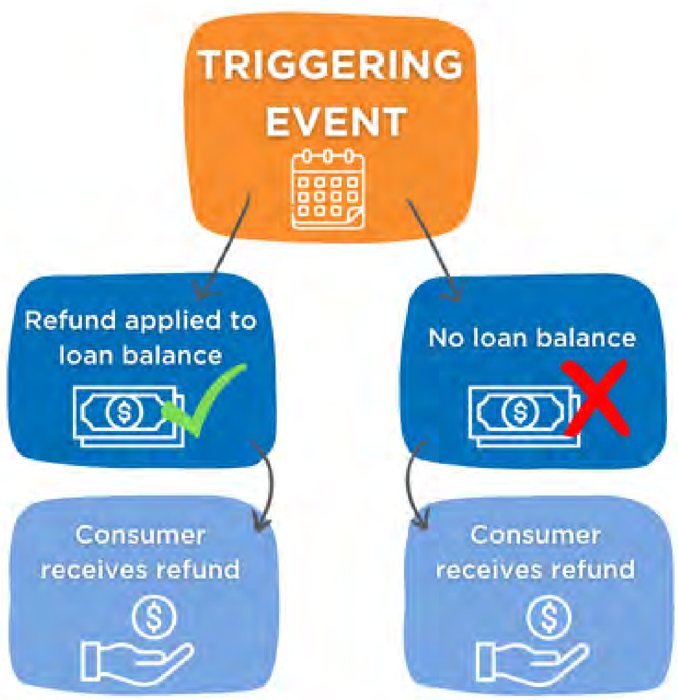
There are a variety of events that can trigger an ancillary product to be cancelled prior to the loan's maturity date. These events are known as triggering events and can include:

- Early payoff of loan
- Repossession of collateral
- Total loss of collateral
- Charge offs

When a triggering event occurs and the product is cancelled, it is likely that the ancillary product outlived the loan. In fact, as loan terms trend longer, most loans are paid off early and the majority of those loans have an ancillary product attached.[1] When a triggering event occurs, a cash refund, or rebate, of the unused product may be due. This refund may be used to cover a deficiency balance and/or the unused portion of the product.

For example, if a deficiency balance exists on the loan the product refund may be due to the financial institution holding the loan. The refund can then be applied to the loan balance. A refund applied to a deficiency balance is most likely the case for triggering events of repossession, abandonment, or total loss. If there are remaining funds after the balance is covered or if there was no deficiency balance, the consumer is eligible for a refund. For example, if a vehicle loan is paid off early a consumer may be eligible for a refund on the unused remainder of the ancillary product.

***Most** loans are paid off early and the majority of those loans have an ancillary product attached.*



Pros and Cons for Financial Institutions

Ancillary products protect consumers and provide a level of assurance for their financed vehicle. For financial institutions, there are both benefits and challenges in providing support for these products. While mutually beneficial to both lender and consumer, facets of ancillary products can become challenging.

Advantages and Opportunities:

- Value-add for consumer: Consumers can opt-in to purchase additional products that offer environmental protections, increased peace of mind, or to extend the life of the vehicle
- Increased revenue and organic growth: Ancillary products help boost additional loan volume and borrower retention
- Additional risk mitigation: These products help provide supplementary protection for financed collateral

Disadvantages and Drawbacks:

- Multiple stakeholders: Increased difficulty in navigating the relationship between lender, dealer, and product provider
- Resource deficit: A lack of administrative resources or technology automation
- Lack of infrastructure: Burdensome need for software and technology to effectively process refunds
- Changing compliance standards: Difficulty adjusting best practices and processes to meet evolving Federal and state guidance

Ancillary products can become complicated as compliance regulations continuously change. Maintaining the infrastructure and resources to service these products in-house become burdensome. *If an ancillary product is cancelled before the borrower receives the full benefit, who is responsible for facilitating the refund?* New regulatory reviews are questioning this and it is known in the industry as **product refund liability**.

Consumer Experience and Ancillary Products

When consumers are searching for an ancillary product, they now have more research options than ever before. In fact, a study conducted by Apex Global Learning found that 80% of consumers said they would not buy from a negatively reviewed business. This means four out of five consumers will look elsewhere if your financial institution is negatively reviewed. A consumer complaint related to product refunds could bear significant financial and reputational costs. The pandemic has also brought additional challenges to this area of the business.

Pandemic-Induced Challenges Impacting Consumer Experience

Just as the economy begins to emerge from the lasting effects of a global pandemic, it's now faced with the impacts of global unrest. These are some challenges facing the financial institution industry and impacting consumer experience:

All financial institutions, regardless of size and location, may be subject to potential liability if effective processes aren't in place.

- **Staff shortages:** Frontline employees felt the weight of the pandemic as many financial institutions minimized branch accessibility to consumers and worked diligently to keep their call centers functioning. Many went remote during the pandemic and have maintained since, making it more difficult to provide the same level of customer care when staffing resources are so strained.
- **Lack of technology and infrastructure:** Few lenders have the necessary infrastructure to handle this complex operation of managing all ancillary products in-house. Technology integrations are necessary to ease the burden of managing product cancellations to ensure accurate, and timely refund remittance to the consumer.
- **Increasing costs:** The strain of the supply chain is immense and rising inflation is a growing risk to the future livelihood of many businesses and accountholders.
- **Increasing regulations:** All financial institutions, regardless of size and location, may be subject to potential liability if effective processes aren't in place. Industry staffing attrition combined with these increasing regulations, has additional strain on balancing compliance with consumer expectation which may result in a negative impact to the consumer with errors or delays, which may equate to fines, penalties, or legal costs to the financial institution.

Investing in technology and automation can help to ease the administrative burden of product refunds and the automation can be adjusted to maintain compliance with increasing regulations.

While some ancillary products are sold directly by the financial institution to the consumer, most ancillary products may be indirect from the dealer or product provider. Many financial institutions are finding themselves in the dark about the product cancellation and resulting regulations tied to these products.

CHAPTER 2

Refund Regulatory Rundown

The regulatory landscape for ancillary products is changing and the scrutiny is increasing toward refunding cancelled ancillary products. Financial institutions must be aware of the current challenges and evolving regulations to navigate changes ahead – and avoid the fallout of inaccurate or incomplete product refund liability.

The Current Regulatory Landscape for Financial Institutions

Staying abreast of the many changes affecting the regulatory landscape surrounding product refunds is challenging. One of those challenges is not all ancillary products are cancelled in the same way. Some ancillary products follow the lifecycle of the loan, and some follow the lifecycle of the vehicle. For example, in the event of repossession, all ancillary products must be cancelled, yet for an early loan payoff only certain products should be cancelled. The complexity of product cancellation continues to increase as state and Federal guidelines shift to the benefit and protection of the borrower.

Generally, regulatory requirements for all financial institution markets are already strictly enforced. Product refund compliance is no different. Across all financial institution markets the liability, timeliness, and accuracy of product refunds are being called to question.

Liability

Currently, the regulatory scrutiny and repercussions are extending across the entire financial institution industry, including banks, auto finance companies, and credit unions of all portfolio sizes.[2] In most cases, the cancelled product is not owned by the financial institution but is provided and serviced by a third-party provider or dealer. This increases the number of stakeholders and adds another layer of complexity to the process, particularly for the lender because the liability of the product refund falls to the financial institution instead of the provider.

Timeliness

When a financial institution relies on the dealer (or product provider) to initiate and follow up on a refund, the financial institution has little to no control over the length of time a consumer waits for a refund. Many state regulations vary on the required timeframe in which the consumer must receive their refund following a triggering event, ranging anywhere from a 60-day window to a 90-day window. These various regulations and timeframes make the cancellation and refund process complex and difficult to ensure compliance with various timeframes and negatively affect the borrower experience.

Accuracy

How the final refund amounts are calculated is sometimes unclear and being called into question. Although both policies and sometimes state laws specify methodologies for calculating refunds (e.g. pro rata method, Rule of 78 etc.) miscalculations are still far too frequent. When a financial institution does not have ownership over the refund process, it is difficult to evaluate the accuracy of the refund amount and disbursement.

Important Compliance Factors and Understanding UDAAP

Beginning in 2019, the Consumer Finance Protection Bureau (CFPB) noted "unfair and deceptive practices regarding rebates for certain ancillary products" as a topic of current and upcoming regulatory scrutiny.[3] This supervisory highlight indicated a heightened focus on ancillary product refund management and liability, and it came up again in 2021 and more recently in the Spring 2022 Supervisory Highlight.[4] Since 2019, several financial institutions in multiple states failed to refund unearned GAP fees to consumers who paid off their loans early. The results have been multiple class action lawsuits against the financial institutions. Interestingly enough, some of these lawsuits were filed in states that had previously remained silent on the issue of refund liability. The heightened regulatory scrutiny indicates that all financial institutions need to be on alert for these types of violations.[5]

Auditor scrutiny, financial penalties, and brand damage are causing many financial institutions to re-evaluate internal procedures.

Auditor scrutiny, financial penalties, and brand damage are causing many financial institutions to re-evaluate their procedures. When a triggering event such as early payoff occurs, consumers may be entitled to a refund of the ancillary services they had on the vehicle loan. Often consumers are not receiving these refunds at all, or if they do, the refund is often inaccurate or slow to be issued.

In many cases a consumer may not know that they are eligible for a refund. However, if a consumer is eligible for a refund but does not receive one, this can be considered a violation of UDAAP (unfair, deceptive, or abusive acts or practices). Additionally, if a refund is issued but not in a timely manner, the effect on the consumer could also be a violation of UDAAP such as "significant financial injury" or the "[erosion of] consumer confidence."[6] Some ancillary products may fall under the category of "products that may carry a high UDAAP risk."[7] UDAAP violations can be impacted by state and/or Federal regulations and guidelines. It's important to keep in mind that maintaining compliance with state and/or Federal regulations does not guarantee compliance with UDAAP guidance and best practice.

Regardless of the origination of the ancillary product (either product provider, dealer, or financial institution), the financial institution that authorizes or accepts the assignment of the loan on the collateral is being held liable for ensuring the consumer receives an accurate refund in a timely manner. Although not every state has a law addressing refund liability, even those without present a risk to financial institutions from plaintiff's attorneys and consumer friendly regulators. Thus, the compliance landscape of product refunds calls for transparency, efficiency, and accuracy. Financial institutions will continue to be scrutinized by regulators to ensure a compliant process for correct and timely consumer refunds. As the compliance landscape is ever-evolving, industry best practice suggests a proactive approach.

The Spotlight on GAP

Presently, GAP refunds on early loan payoffs are often receiving the most scrutiny. While nearly every state takes a stance on who is responsible for refunding the borrower in the event of a cancelled GAP waiver, all 50 states are not aligned on their positioning, causing confusion and further complexity. Additionally, the volume of GAP refunds is sizable. Recent data shows three credit unions in a single state collectively refunded more than $6M in GAP fees which impacted over 22,000 members.[8]

In 2021, a large national bank settled for $500M to end the GAP Insurance Class Action Lawsuit.[9]

February of 2022, California introduced new legislation regarding GAP, AB 2311 was signed into law in September of 2022.[10]

Scrutiny from the CFPB and certain state courts directed at financial institutions for GAP waivers indicates that more regulatory examination is coming. These GAP-related legal developments are impacting and will continue to impact business practices for auto loan servicing.

CHAPTER 3

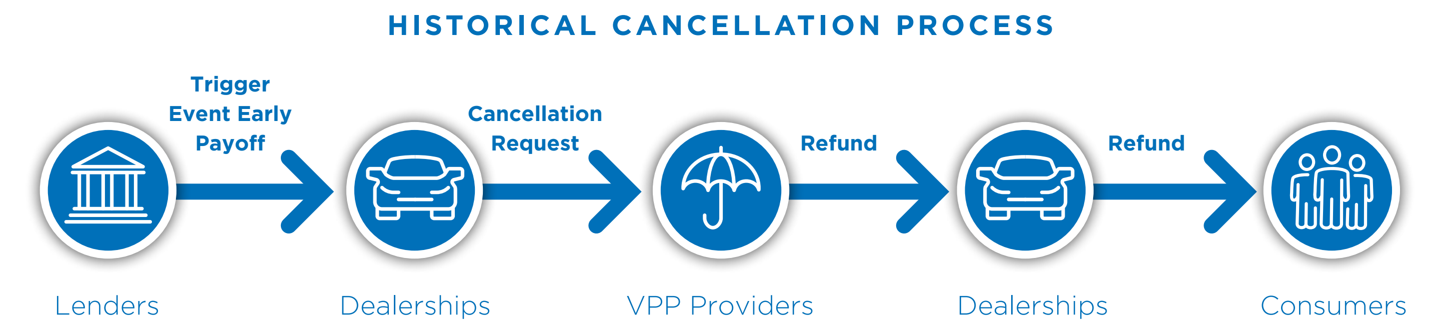
Solving for Product Refund Liability

Few lenders have the infrastructure to take on an audit-worthy, end-to-end refund process. This chapter explores two possible approaches to product refund liability and a solution that solves for compliance and infrastructure concerns.

How to Get Started: Two Possible Approaches

Historically, a financial institution would redirect the consumer to the dealership (or a product provider) to issue the correct refund amount. This approach is no longer considered best practice and it may not fulfill financial institutions' regulatory obligation.

Financial institutions have two options to approach the liability of product refunds:



Approach #1: Build and manage a refund process internally.

Managing the product refund process in-house is no small task. Here is a glimpse of what it will take:

- Significantly increase staff resources
- Develop internal refund processes and clear business rules
- Ensure internal legal, operations, and accounting teams are in sync with processes and changing guidelines
- Track receipt of all refunds to provide an audit trail to auditors and regulators

This approach is not without its own set of challenges. Internal management of the process can be burdensome, with high operating expenses and involvement across multiple internal departments. Additionally, it is very difficult to monitor regulations across multiple states. The rigorous audit requirements for product refunds can become stressful and taxing to an underprepared infrastructure.

Approach #2: Integrate a proven technology to streamline and manage product refunds.

With multiple stakeholders, it's progressively more difficult to navigate the relationship between lender, dealer, product provider, and consumer. With this technology approach, the financial institution still accepts the liability of refunding the consumer but does not have to develop an internal process to monitor, track, calculate, and remit refunds to the consumers. Instead, the financial institution partners with a third-party vendor that has the technology and infrastructure in place to manage the product refund process. This way, a financial institution can maintain ownership and control of the refund process and the timeframe in which refunds are issued without building the product refund technology. Even though product refunds are an arduous process, this approach diminishes many of the challenges posed by servicing ancillary products.

This approach helps financial institutions maintain regulatory alignment by:

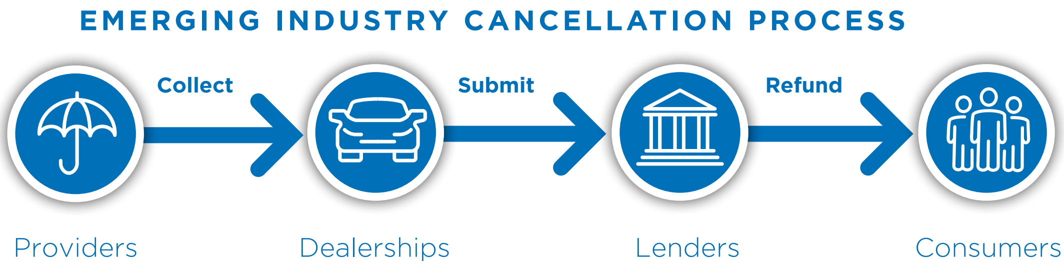
- Implementing an end-to-end product refund solution from the filing of the triggering event to when the refund is received by the consumer
- Accurately defining payoff and/or deficiency balance amounts for credit bureau reporting
- Maintaining an auditable trail of the refund amount for audits
- Reducing cycle times to 45 days or less to ensure staying beneath the 60-day threshold (the shortest required cycle time currently documented)
- Tracking receipt of refund payment to consumer
- Real-time access to dealer contact information or out of business updates
- Gaining timely updates on changing compliance requirements

Choosing a vendor partner to oversee the process can transfer the operational difficulties and optimize the process. For example, a product refund vendor can provide lockbox services, which greatly reduces the accounting load on refund payments by compiling, logging, validating, and remitting all refund proceeds directly to you with specific instructions.

> ***It's progressively more difficult difficult to navigate the relationship between lender, dealer, product provider, and consumer.***

The New Standard of Success

It is time for financial institutions to take ownership with a proactive and borrower-centric stance. While lender compliance is a primary concern, the byproducts of a product refund solution benefit the consumer as well, by ensuring that consumers are receiving accurate refunds.



Outsourcing the process of ancillary product refunds to a trusted partner can help gain much needed efficiencies while protecting your financial institution and borrowers.

CHAPTER 4

Takeaways and Next Steps

As financial institutions continue to grapple with staffing shortages and a myriad of economic challenges, managing an intricate process like product refunds is becoming increasingly difficult. This final chapter will help financial institutions gain strategies to feel confident about tackling product refunds in a compliant manner.

5 Takeaways for Product Refund Liability

Regulators are keenly focused on ensuring ancillary products are serviced and cancelled properly. Managing and servicing ancillary product refunds is becoming a critical business practice for financial institutions. The following considerations can help financial institutions transform product refunds from an afterthought to a strategic approach:

1. Recognize compliance complexities

Product refunds are a complex area of the business. There are multiple relationships to manage, including dealers, product providers, consumers, and regulators. There are state-by-state variations on the level of responsibility the lender bears for covering deficiency balances and refunding the consumer. Additionally, every ancillary product may have different rules for how refunds are calculated and tracked. Possible violations of UDAAP pose a litany of potential risk as UDAAP is based on principles rather than technical rules. Recent class action suits highlight that regulators, consumer-focused attorney groups, and litigators are looking to lenders as the responsible party to handle product refunds.

2. Prioritize transparency

Transparency in the product refund process is no longer a luxury. It is a must. In the new regulatory landscape, there is little room for unclear ownership, inaccurate tracking, or calculating errors regarding product refunds. Transparency provides increased accuracy. All stakeholders benefit from a more accurate and efficient refund process. Financial institutions gain a clear sense of ownership, can reduce errors, and strengthen dealer and product provider relationships. Regulators have a trail for audits, and consumers receive accurate and timely refunds.

3. Employ operational technologies

Data integration is invaluable to the product cancellation and refund process. The right technology infrastructure will use this data to calculate refund amounts, track when refunds are due and validate those consumers received their refund. Product refund technology also gives the dealer (and potentially product provider) the opportunity to participate in the process. This not only enhances the relationship with the dealer (or product provider) but also fortifies transparency in every step of the refund process.

Automation reduces errors through calculated formulas, customized reports, and reduced touchpoints between parties. Reports are generated for an audit trail of refund calculations, amounts, and dates, and lighten the administrative burden.

4. Reduce risks

Minimizing risk exposure doesn't have to be just protecting loan portfolio and revenue growth; financial institutions can also protect their consumers' financial well-being by complying with UDAAP and other local regulations.

Other risk mitigation benefits include:

- Control of owed refunds/covering deficiency balances
- Accurately define payoff and/or deficiency balance amounts
- Expedite refund recovery and validate receipt of refunds
- Improve audit trail and reduce delays and errors
- Reputational protection and increased consumer trust

The risk exposure surrounding refunding cancelled products is ongoing and must be measured diligently for compliance with all state and Federal regulations. By taking a proactive approach, this process reduces portfolio risk exposure and optimizes the consumer's auto loan experience.

5. Strategize for success

A reactive approach to compliance, transparency, and automation opens the potential for regulatory scrutiny, or even compliance breach. A proactive approach puts the management of ancillary products in the hands of the financial institution to track and monitor.

This strategic approach helps mitigate regulatory and reputational risk by involving all applicable areas of the business with a clear and apparent audit trail. As you build your product refund strategy, input from legal, operations, and accounting should be gathered to create a product refund infrastructure that identifies areas of risk exposure. A strategic approach protects consumers, stakeholder relationships, and the loan portfolio.

Lenders must fully understand their obligations and applicable laws regarding product refund liability:

- Which GAP waivers the lenders want to finance
    - Lenders need to know policy and state requirements relative to pricing, disclosures, and underwriting risk based on the purchasing of GAP waivers assigned within Retail Installment Sales Contracts
- Refund Calculations
    - Lenders have the regulatory burden to make consumers whole, accurately and in a mandated time-frame
    - Lenders need a system of record so that upon routine audit or exam there is a clear line of sight regarding the documentation of the refunds - proof of cancellation, communication exchanges, receipt of refund made, among other dispositions of the refund processes

Facilitating collaboration between lenders, dealers, and product administrators is the best way to pivot as regulations continue to change with the amplified scrutiny of product refund liability.

In Summary

When a triggering event cancels an ancillary product, financial institutions have an opportunity to take the lead by strategically partnering to manage the process. Facilitating the lifecycle of ancillary products is not without its challenges. Financial institutions continue to be held accountable for calculating and issuing product refunds to consumers. Establishing a product refund process both prioritizes and protects consumers, while mitigating your institution's risk. Ancillary product servicing can be optimized with an end-to-end process for refunding consumers money due on their cancelled ancillary auto loan products. With a streamlined process for refunding consumers, multiple areas of the business are optimized, the consumer relationship is enhanced, and compliance is improved.

About Allied Solutions

Allied Solutions is one of the largest providers of insurance, lending, risk management, and data-driven solutions to financial institutions in the US. Allied Solutions uses technology-based solutions customized to meet the needs of 4,000 banks and credit unions, along with a portfolio of innovative products and services from a wide variety of providers. Allied Solutions is headquartered in Carmel, Indiana and maintains several offices strategically located across the country. Allied Solutions is a wholly owned and independently operated subsidiary of Securian Financial Group.

RefundPlus® from Allied Solutions is a first-to-market, end-to-end solution that helps financial institutions tackle product refund liability and optimize the refund process. This solution combines our mastering knowledge of the financial institution industry with technology to streamline product refunds on cancelled products, improving consumer experience, and ensuring refund efficiency and accuracy.

For more information, please visit: www.alliedsolutions.net/solutions/manage-risk

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