a CALLAHAN COLLECTION 2015

edition 2

AN INDIRECT OBJECT OF AFFECTION

FOR MORE CREDIT UNION STRATEGY & PERFORMANCE VISIT

CREDITUNIONS.COM

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PUBLISHED BY

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Credit unions held more than $102 billion in indirect auto loans Nationwide as of June 2014, according to Callahan & Associates. That's the largest balance in the past 10 years. Indirect lending offers benefits such as serving new members the credit union might not otherwise have reached and the opportunity to deepen relationships with members who come through the channel.

Building a strong indirect program require dues diligence and the ability to cultivate relationships. That's why this Callahan Collection showcases the strategies different credit unions employ to improve the efficiency of indirect lending, establish contact with local auto dealerships, and enhance dealer partnerships.

WSECU GOES PAPERLESS IN 2013

How the Washington credit union turned its indirect lending program into a fully electronic business in 16 months.

BY DREW GROSSMAN

In July 2012, the chief lending officer of Washington State Employees Credit Union announced at a Callahan-sponsored CLO roundtable that WSECU would go paperless in 2013. According to CFO Keith Troup, within 17 months the credit union would complete all loan applications and contracts electronically, and it would start with its indirect channel.

WSECU ($2.2B, Olympia, WA) is an active indirect lender that, as of December 31, 2014, attributed more than 31% of its loan portfolio to new and used auto, according to the Search & Analyze function on CreditUnions.com. Since summer 2012, the credit union has been rolling out its paperless indirect lending process, and since October 1, 2013 the credit union no longer accepts paper loans from its indirect partners.

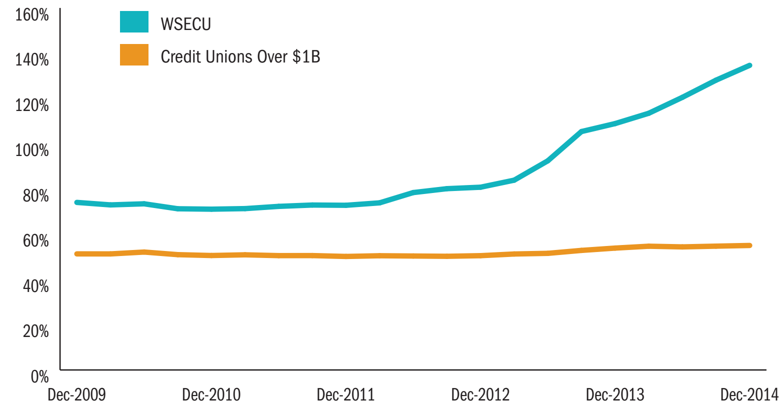
Before WESCU invested in a digital process, its records department had to manually scan all newly generated paper into the institution's lending system. Despite the upfront expenditure, the new electronic process will increase worker efficiency and reduce long-term paper and storage costs.

Leadership at WSECU first learned about the paperless option during a 2011 Credit Union Direct Lending conference about smart funding, which is the electronic distribution and receipt of loan contracts. CU Direct Corporation, a CUSO that provides lending technology to credit unions, owns the indirect lending program featured at the CUDL conference.

"We came away from that conference saying, 'this is something we want to bring back to our shop," Troup says.

The credit union started pushing smart funding through CUDL's plat-

INDIRECT AUTO LOANS/TOTAL AUTO LOANS - WSECU



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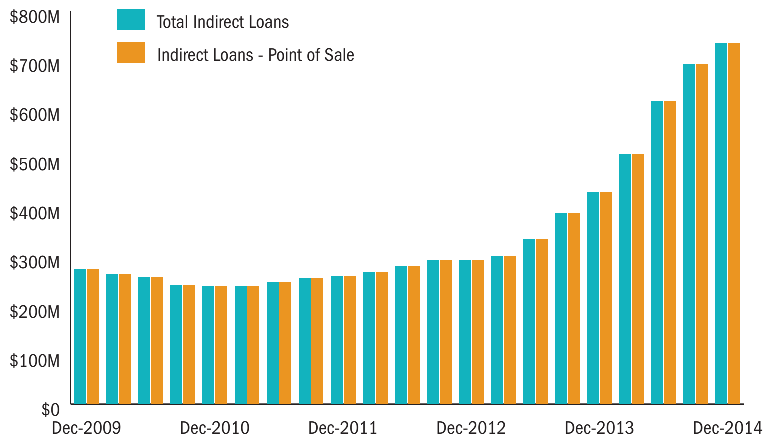
INDIRECT LOANS OUTSTANDING BY TYPE - WSECU



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form in the summer of 2012. At the time, it received 20% of its indirect loan contracts electronically. Today, that rate is 90-95%. The credit union pushed smart funding by reaching out to dealers and pitching the benefits of sending loan funding contracts via electronic channels.

"Every time our processors talk to a dealer, they're asking 'do you know what smart funding is?'" Troup says. "The way we pitch it, [it's] for them to save money and get their money faster from us."

Smart funding saves the dealer money in overnight shipping costs, which is how most were sending loan contracts, and it saves time because documents are immediately available for review. For the credit union, smart funding allows for a speedier funding process. The efficiency created by smart funding will allow the credit union to repurpose an entire department.

"It's going to cut down a lot of people's time in the processing of loan contracts," Troup says. "It's going to eliminate one department's activity completely in getting consumer loan documents into the system, so perhaps there will be other things those people can do with the freed up time that they have."

To gauge the success of its smart funding initiative, WSECU is monitoring its funding ratio, which is the amount of loans acquired from dealers that are ultimately approved. The funding ratio of approved applications for indirect auto was up to 57% from 52% over the nine-month period since the smart funding roll out. Additionally, the funding ratio of approved applications for RV was up to 67% from 47% over the same nine months. The credit union attributes increases in the funding ratio primarily to the increased use of smart funding.

"We have been able to drive up that funding ratio," Troup says. "It's still not where we want it to be, but it's higher for dealers that use smart funding than for dealers that don't."

The paperless system has also helped increase the efficiency of loan processors. According to Troup, many things the credit union has done have contributed to the increase in consumer loans processed and funded per loan processor, but the reduction in physical paper is a major factor in its recent gains. For example, in July 2012, WSECU loan processors processed or funded an average of 145 consumer loans. In July 2012 that number had jumped to 175, meaning each FTE processed or funded an additional 30 loans.

As the October 1 deadline approached for dealers to switch to electronic smart funding, WSECU ran a promotion to reel in stragglers. Each time a dealer submitted a contract electronically, WSECU entered it into a drawing to win a suite at a Seattle Mariners baseball game.

"We're having a contest for our dealers to provide them a positive reason to make this switch," Troop says. "It's our last-ditch effort for the few dealers that are holding out. We hope that will be enough to get them over the edge because on October 1 and October 2 we do not want negative experiences with dealers that are sending us paper agreements."

The credit union is building off its paperless indirect channel success by creating paperless loan applications for consumer loans. As of September 2013, 20% of remotely generated consumer loans were electronic, and the credit union's goal was to make its consumer lending completely paperless, as well.

"We would love to see [remote electronic loans] be much higher than 20%," Troup says. "In our mind, it's about creating a remote member experience where they're comfortable starting and finishing an application remotely."

Perhaps it's a fortunate coincidence, but WSECU's percentage of indirect contracts coming in electronically was also 20% only a year ago. Such insight bodes well for the consumer lending side.

THE ALTERNATIVE TO DEALER PARTNERS

Car-buying services can support a credit union's indirect strategies, whether as a substitution for or an augmentation of dealer relationships. Learn how BCU and Excel Federal Credit Union leverage car buying services.

BY DREW GROSSMAN

Credit unions have always had a love hate relationship with auto dealers. On the one hand, cooperatives value their dealer partners for extending the credit union's reach into the dealership, where members purchase a vehicle. On the other hand, dealers don't always send members back to the credit union for the loan.

One solution is to partner only with dealers who guarantee that any member you send their way will be returned to you for financing. The best dealer partners also have competitive pricing, a good selection of vehicles in your members' price range, and showrooms near your branches. Still, sometimes the relationship just doesn't work out, and when that happens, there's another option: car buying companies.

These services can help take your auto lending business to the next level whether you partner with them exclusively or use them to augment your relationships with dealers. Either approach is fine, but credit unions, like the two profiled below, often use car buying services as part of a broader business plan. As a result, the credit unions featured here selected car buying partners, which may be national or regional, and structured incentives to support vastly different strategies.

A DUAL STRATEGY FOR A NATIONAL MEMBERSHIP

At BCU ($2.2B, Vernon Hills, IL), partnering with both car buying services and dealers was the logical way to serve a membership that has gone steadily national since the 1990s. Although BCU began by serving the community in northern Illinois, a series of mergers over the past two decades and partnerships with a number of national select employee groups has taken its membership national. At the same time, as Illinois's fourth largest credit union, BCU still needed to provide top service for members at home. That led to the dual strategy of using both car buying companies and dealers.

"We use the national auto buying service primarily to serve members who are across the country," says James Block, vice president of consumer lending at BCU. "Whereas people who are in the northern Chicago suburbs, we primarily work with through our direct dealer relationships."

The two strategies complement each other well. Where the credit union doesn't have a critical mass of members to justify forming its own dealer relationships, the auto buying service gives BCU access to the dealers that members are likely to shop at. BCU has had relationships with local auto dealers for more than a decade, but the auto buying service partnership developed in the past two and a half years. During that time, the credit union's auto loan penetration has grown from 18% in mid 2011 to 22.6% as of March 2014, according to Callahan & Associates Peer-to-Peer data.

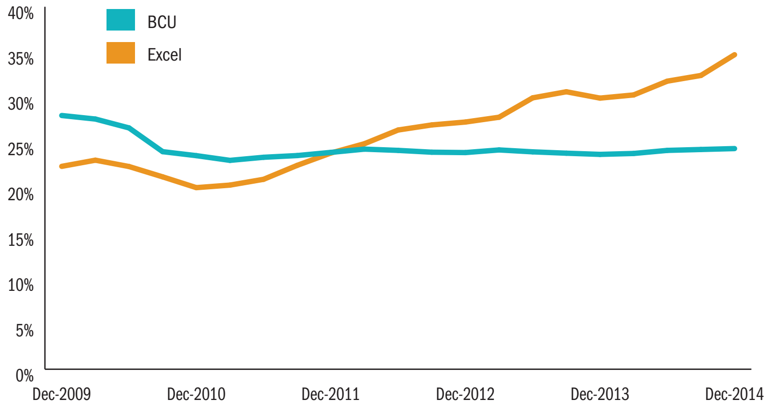
When choosing which car buying service to work with, BCU looked at two things, national coverage and good referrals.

"We tested it internally before marketing to members," Block says. "Relationships are driven by dialogue and a clear, shared definition of success. That way each side knows what it needs to deliver."

Although BCU refers national members to the car buying service and local ones to its dealer partners, the loan costs the same for both the member and credit union. Sometimes, however, BCU lowers the rate as an incentive for members to use the car buying program.

Working with car buying companies does have a

AUTO LOANS/TOTAL LOANS - BCU +EXCEL



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downside. Because BCU doesn't have a direct relationship with the dealer, it must rely on the car buying service's relationship with that dealer instead. That's why communication with the car buying company is so important.

By going through a third party, "you lose control of the messaging," Block says. "It's difficult to manage the behavior of the dealers when you're not directly interfacing with them."

BCU has built strong relationships with local dealerships over the years so that the two parties can find a mutually beneficial agreement that serves the best interests of credit union members. As a result, BCU rarely loses financing to other financial institutions because of the dealer. In the credit union's experience, that scenario is more common with national car buying services, though it only has happened a few times. As BCU strengthens its relationships with the companies, it expects the number to become smaller still.

ENSURING QUALITY SERVICE

Unlike BCU, Excel Federal Credit Union ($93.7M, Norcross, GA) works only with car buying services and has two partners: Car Solutions, a Georgia-based service that works exclusively with credit unions, and Enterprise, which has customers nationwide.

That strategy made sense for two reasons. Excel's footprint, which extends throughout Georgia, is too large to pinpoint the dealerships its members are likely to patron. More importantly, though, the credit union doesn't participate in any indirect lending, the kind of partnership many dealers prefer to have with cooperatives. The credit union generates all auto loans through its branches or website.

Excel has concerns that dealers don't always have the members' best interests at heart, and the credit union doesn't want any negative experiences to reflect poorly on its own organization. Excel is so wary of dealers that it has a video on its website explaining how they can advertise seductive low rates that ultimately end up costing the consumer more.

The credit union is also troubled by the inherent inequities of the dealership experience, which requires customers to haggle over pricing. That means some members may get a bum deal, and "we do not want the member to be disappointed," says Bonnie Trappe, a senior vice president at Excel Federal.

With some car buying services, though, the incentive structure is different. For instance, instead of paying commissions on high price tags, Excel rewards car buying services for finding the right car for the member at the best price, a philosophy that is more in sync with the not-for-profit model members are accustomed to seeing at the credit union.

In a sense, the right car buying service can also help reduce some of the credit union's risk with the loan. After all, when reviewing a loan application, underwriters consider both the borrower's qualifications and the car's condition and price.

"When we approve a member to purchase a car, we're looking at the member's credit as well as the quality of the car they're buying," Trappe says. "We feel that by having them go through Car Solutions and Enterprise, they're getting a good quality car."

WHAT DO DEALERS LOOK FOR IN AN INDIRECT LENDER?

In this Q&A, Tim Rivers, finance director for Gunn Honda in San Antonio, TX, discusses loyalty and respect in the indirect relationship. Spoiler alert: Referring members back to the dealership plays an important role.

BY BROOKE C. STODDARD

As finance director for Gunn Honda in San Antonio, TX, Tim Rivers knows a thing or two about forming strong relationships with credit unions to generate business for lender and dealer alike.

Gunn Honda and its parent company, Gunn Automotive, have indirect lending agreements with half a dozen credit unions. Rivers attributes the dealership's success to the 25-year relationship that Gunn Honda has had with cooperatives. Although two credit unions work with the dealership through web-based tools like Dealertrack, Gunn Honda primarily finds credit unions through CUDL, an indirect lending network that connects cooperatives with dealers. Gunn Honda does the most business with Security Service Federal Credit Union, which issued more than $10 million in loans to the dealership's customers during one recent 90-day period.

WHAT MAKES A GOOD INDIRECT LENDING PROGRAM?

TIM RIVERS: Good relationships that are built up over the years on loyalty and respect. Good relationships are what this business is. We have to understand the credit unions and they have to understand us. We think they do a good job of that.

IS FACE-TO-FACE CONTACT IMPORTANT?

TR: It's important. Most of the credit unions make a point of sending their sales reps to us from time to time or hosting events at which we can get together. It's all part of building the relationship.

WHAT CAN HARM AN INDIRECT LENDING RELATIONSHIP?

TR: One way is for a credit union to have its indirect and direct lending efforts out of sync. Credit unions should send their indirect lending members back to us for a second or subsequent car loan rather than have them sign at the credit union with the direct lending program. The best credit unions do this and are consistent about it. Again, it's part of building a trusted, well-functioning relationship. I'll stop dealing with a credit union that does lobby lending with persons who come here first, want one of our cars, and then go to the credit union to get the loan.

> “When a customer comes in late on a Friday night and signs a contract, we need to know that we are going to get the funding. The best credit unions for us are the ones we know have been consistent over the years, so that we can count on service to a certain level.”

WHAT CAN HELP AN INDIRECT LENDING RELATIONSHIP?

TR: Consistency. When a customer comes in late on a Friday night and signs a contract, we need to know that we are going to get the funding. The best credit unions for us are the ones we know have been consistent over the years, so that we can count on service to a certain level. It’s important because here in Texas when a contract is signed it is binding from that moment. We need to feel we are working with a lender who will be consistent with the standards it has shown in the past. This is really key.

HOW CAN A CREDIT UNION IMPROVE ITS CONSISTENCY?

TR: It helps for a credit union to have a designated buyer per store. Of course, each buyer will have more than one store. But when that store calls, it’s a really good idea to have the call go to the same person as many times as possible. Some credit unions assign the calls randomly; that does not work as well for building a relationship. For example, when I call, I want a person whose standards I know, not someone whose standards I don’t. Of course, people are rotated so they don’t get stale, but consistency is something to shoot for. This goes for the supervisors of the buyers too; they should know and have a set relationship with the dealer.

WHAT OTHER THINGS CAN CREDIT UNIONS DO TO MAKE THE RELATIONSHIP WORK BETTER?

TR: There are variables in every potential sale. Don’t be so stringent you don’t have any flexibility.

NEW BUYERS ARE GOING TO COME IN FROM TIME TO TIME. WHAT DO YOU DO THEN?

TR: New buyers can sometimes be aggressive, as in trying to establish a place in the market. We’d rather see them be conservative early on, and then grow with time and set a record by which they can be consistent. We don’t want to see buyers doing one thing, then changing or have change forced on them six months later.

WHAT OTHER ELEMENTS ARE IMPORTANT?

TR: Payment should be swift. It makes our business people happy. Credit unions and dealers can work out their own agreements about flats and spreads. The better the payments are for the dealers the more they are going to like the credit unions — but whatever the kind of payment, it needs to be swift.

WHAT CAN CREDIT UNIONS DO TO IMPROVE THEIR RELATIONSHIPS WITH CAR DEALERS?

TR: Some credit unions have people who had earlier careers at dealerships. These people understand what our problems and needs are and tend to really help a relationship. Training can vary also; some credit unions could do better. I think going to CUDL conferences are helpful. Of course, we need to understand the credit unions and treat their members properly, carefully, and ethically — again, it’s about creating a working, respectful relationship.

WHAT TECHNOLOGIES DO YOU SEE COMING ALONG?

TR: I expect one day people won’t have to come in to the dealership, but we are not there yet. There are safeguards and we need to see a photo ID. But people can already pre-apply. They can do this with mobile apps. At the moment, we prefer using faxes rather than e-contracting. That may change.

DO YOU LIKE USING CUDL?

TR: We do. We like the fax-funding feature. Fax-funding is a large part of the operation’s success. We receive funding the same day, and that makes for a happy CEO, CFO, and accounting department here. Moving money quickly is something we really want, and the credit unions that do it best we are very happy with.

HOW TO FORM CLOSE TIES WITH 600 DEALERS

In this Q&A, Charles Goss, chief lending officer at Security Service Federal Credit Union, and John Worthington, chief communications officer, discuss the credit union's indirect auto lending program — the largest in the nation — and how to provide dealers with consistency and service.

BY BROOKE C. STODDARD

Security Service Federal Credit Union ($8.3B, San Antonio, TX), the nation's eighth biggest cooperative, has the industry's largest indirect auto lending program, one that began in 1990 and has grown to include more than 600 dealers today. Here, Security Service's Charles Goss, chief lending officer, and John Worthington, chief communications officer, talk about how the credit union fosters and maintains close ties with so many dealers without diminishing the quality of those relationships.

WHAT ARE THE MOST IMPORTANT ELEMENTS OF A GOOD INDIRECT LENDING PROGRAM?

CHARLES GOSS: We stress relationships and consistency. We work on these every day. Back in 2009 many organizations stopped lending or severely cut back. To be sure, we became more conservative — safety and soundness were our first priorities — but we made a point of being there for our dealers. We felt it was a matter of consistency and service. We found that they were grateful for that and that acting as we did strengthened our relationship with those dealers. We also learned they have long memories. They remember who stood by them and who bailed out.

When we say relationship we mean lots of things. Relationship includes how fast you can get money to the dealer, how consistent you are in purchasing decisions, and so on. A dealership is a cash flow business; getting funding to them means a lot. Our goal is to transfer money the same day or within 24 hours.

In addition, communication is important. We want to listen to dealers with a sense of urgency. Dealers have the ability to rehash deals with us and that is important to them. They want to be able to call someone they know and re-talk a deal. We work to have someone on our end of the line who knows them, can listen well, and resolve the problems. We want to give dealers answers quickly, send them funds quickly, and be consistent in our dealings. When you boil it down, this is a people business.

HOW IMPORTANT IS TECHNOLOGY?

CG: We work hard at having the best technology and a competitive advantage with our technology. Speed is important in indirect lending.

But we also look at the program holistically. We can't just focus on technology. We monitor what others are doing. We work to be competitive with our rates. We may not always be the rate leader but we work hard to deliver the best service and to be the most consistent.

DOES A PROGRAM IMPROVE OVER TIME?

JOHN WORTHINGTON: We've been doing indirect auto lending since 1990. Our program has improved with time. It improved because we worked at it and continue to work at it. We question our paradigms and wonder if what we did yesterday is going to be relevant tomorrow. We look for incremental improvements, which over time amount to large improvements. We're always looking for ways we can be more efficient and effective and build better relationships with dealers. It works. Otherwise, you don't improve; you get stale.

YOU SAID INDIRECT LENDING IS A PEOPLE BUSINESS. HOW DO YOU WORK ON THE PEOPLE SIDE OF IT?

CG: We send our staffs out regularly to meet with dealer people, talk to them, take them to lunch, put a face to a name. We send our staff during slow times in the middle of the week. Dealer people like to do business with persons they know and like. One benefit of having been in indirect lending for a long time is that you meet the people who work at dealers when

Q&A

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Q&A

JOHN WORTHINGTON
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OFFICER, SECURITY SERVICE
FEDERAL CREDIT UNION

they are young and getting started, and you grow and evolve as they grow and evolve. We now know lots of dealership owners, general managers, and top finance people from when they started in the business.

HOW CAN YOU MAKE A RELATIONSHIP BETTER?

JW: One way is to understand the relationship is two-way and symbiotic. When dealers hold events to raise money for their charities, we join as sponsors. When we hold events for our foundation, the dealers who really want to develop the relationship help out as sponsors. Mutual aid makes stronger relationships.

HOW DO YOU TURN MEMBERS BROUGHT IN THROUGH INDIRECT LENDING TO BE MULTI-PRODUCT MEMBERS?

CG: This is a constant challenge with all credit unions that have indirect lending programs. Much of that success has to do with the products and services you can offer these members. Intelligent data mining and longevity help. You try one thing after another and over time learn what works and what does not. You keep trying for steady improvement. We've found that over time we get better at broadening new member usage of our products.

HOW IMPORTANT IS PERSONNEL CONSISTENCY?

CG: It's pretty important. Lending in many ways is subjective, and each loan officer is a little bit different. The dealer gets used to particular loan officers. If he's working late at night and knows the loan officer is off-duty, he'll craft a deal in a particular way because he knows this is the kind of deal that the loan officer wants and can approve. If he does not know that loan officer well, he won't be able to do that. People should work with one another over time. It really helps.

WHAT COULD HARM A RELATIONSHIP?

CG: Not providing world-class service, not being consistent with your decisions, and not funding the dealer contracts in a timely manner. There are other things too: not listening to dealers wanting to rehash a deal, taking too long to deliver funds, things like that.

HOW DIFFICULT IS EXPANDING AN INDIRECT LENDING PROGRAM?

CG: It's difficult. First, there are the limitations of the field of membership — you cannot just go anywhere. If you want to try, though, you need some economies of scale that will back you up. You will be new in an area and that's tough. You also have to staff your new effort and that's costly.

BOILING IT DOWN, WHAT HAS MADE FOR SECURITY SERVICE'S INDIRECT LENDING SUCCESS?

JW: Three words: relationship, relationship, relationship.

THE SWITCH FROM RATE MARKUP TO FLAT FEE

A considerable market share gave Member One Federal Credit Union the leverage it needed to change how it compensated auto dealers.

BY DREW GROSSMAN

Last November, Member One Federal Credit Union ($680.5M, Roanoke, VA) accomplished something that cooperatives often hesitate to do. The credit union changed the way it compensated dealers for auto loans, switching from a rate markup to a flat fee in part because of recommendations from the Consumer Financial Protection Bureau.

Because dealers took a slight haircut with the flat fee, Member One was fully prepared for the backlash, anticipating as much as a 20% drop in its auto lending business.

"Other leading lenders in our market hadn't gone to flat fees, and we were initially concerned about changing that process," says Tim Rowe, chief risk officer at Member One.

Then the unexpected happened. Dealers liked the change, preferring the simplicity of the flat fee to a markup plan that could cause rate confusion. Since instituting the switch in November 2013, Member One has enjoyed a boom in business, with the dollar value and number of auto loans it originates up more than 40%. The successful switch is a reminder that credit unions sometimes have more leverage with dealers than they think especially if an institution has built up its market share over time.

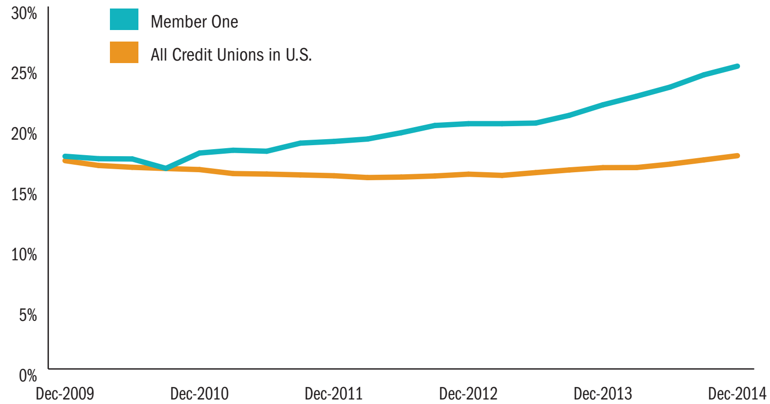
GROWING LEVERAGE

When Member One first started its indirect lending program in 2000, the credit union had exactly zero leverage thanks to a modest 8% auto loan penetration rate and a puny 2% market share. In fact, far from being in a position to negotiate a fee structure with its dealer partners, Member One needed them more than the other way around.

"To stem the flow of business that our members took elsewhere, we initiated our indirect lending program to help put us on a level playing field with other lenders," Rowe says. "And that meant paying the rate markup, which was the way that loans were made at dealerships."

The exact dealer markup rate varies depending on the lender (a credit union or other financial institution) and sometimes it varies even between programs at the same lender. A rate markup of 2% could also fluctuate based on interest rates, terms, dollar amount, new vs. used, and credit score. As an unproven auto lender in the region, Member One had no choice but to accept the dealers' terms, even though most

AUTO LOAN PENETRATION - MEMBER ONE



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credit unions opt for the flat fee instead.

By 2013, however, Member One had become enough of a lending powerhouse that it could flex a little muscle and announce the new flat fee to its dealer partners. As of 4Q 2014, Member One's auto loan penetration rate stands at 25.06% compared to a national average of 17.65% for all credit unions, according to Callahan & Associates Peer-to-Peer data. The credit union also commands a much larger market share of more than 15%, up from 10% just last year.

A SIMPLER FEE STRUCTURE

With a flat fee, a credit union might pay the dealer 1% of the financing over the loan term instead of marking up the interest rate, which would normally cost more and is more vulnerable to change.

An added benefit is the fee's simplicity. Under the old system of marked up rates, borrowers could get a different rate depending on whether they financed the loan at the credit union or the dealership. The system was confusing not only to members but even to dealership personnel and the credit union's own staff. Having a common rate simplified things for everyone by eliminating an extra step from the auto buying process, which was the back and forth discussions between the credit union and dealer to sort out the rate markup confusion.

In addition, the credit union hired a dealer representative who travels to Member One's dealer partners to facilitate financing. The credit union has also hired more underwriters to keep up with the increased loan application volume.

"The dealers welcome the change," Rowe says. But they may not be the first to recommend the flat fee because it means less money for them, he adds.

As for why dealers should get a kickback at all, Rowe views the fee as a necessary marketing expense because members want one stop shopping at the dealership. Without the fee, dealers would have no incentive to send the business back to Member One.

"We would rather make the loans ourselves and have members separate financing from the auto purchase and the trade in and have three distinct transactions," Rowe says. But there's one problem. "Nobody wants to do business that way."