THE CAPITOL FORUM

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Auto Financing: Takeaways From Subprime Auto Financing Conference: Negative Incentives in Dealer-Lender Relationship Drive Problems In Market, Long-Lasting Harms To Consumers

On June 2, *The Capitol Forum* held an event on Capitol Hill to discuss subprime auto financing. For the full transcripts, please use the follow links:

- Introduction & Opening Address by Joe Valenti, Center for American Progress;
- Panel 1: Market's Effects on Industry Stakeholders & the Economy;
- Panel 2: Market's Effects on Consumers;
- Keynote by Doug Gansler, BuckleySandler & Former Maryland Attorney General.

Event Highlights

Influential think tank calls for enhanced oversight, regulation. The Center for American Progress's Joe Valenti said incentives in the auto loan market are misaligned, and there is a need for more data, more transparency and more supervision and regulation.

Panel 1: Risk management expert cites leading, lagging indicators and predicts that music will stop. Nick Clements from Mangifymoney.com said there are three leading indicators – origination by third parties without enough skin in the game, very loose verification standards and strategies to adjust to the reality that customers can't afford what they are buying (lengthening of terms) – that should be setting off alarms. He added that lagging indicators like delinquencies and defaults are starting to show troubling increases in securitization trusts in the data of subprime originators. Nick also predicted, "As the underwriting standards continue to get looser and these early vintages continue to deteriorate, at a certain point the music will stop…At a certain point, defaults will come through too high. Investors will get too nervous. And institutional investors tend to run in herds. So right now they're buying. At a certain point they will stop. And when they stop, you will see a lot less credit available to make used car purchases. You'll see a lot of people stuck in underwater subprime auto loans. And the prices will come dramatically down at that point in time. In my mind, that much is obvious."

Panel 1: Kelly Blue Book representative describes supply coming into used car market from huge sales numbers and increase in leasing. Rebecca Lindland from Kelly Blue Book talked about the recent history of used car prices, "The reason used cars were so expensive was because there weren't very many of them. Because in 2009 and 2010, we had terrible auto sales. So new cars were not being sold. We were down to ten million units a year. So as the markets recovered – we did 17.4 million last year – there are going to be the supply of used cars will increase, which will hopefully help some of the pricing there. Demand obviously will increase as well, but hopefully with more supply. We're also seeing an increase in leasing, which gets back to the affordability issue, whether people will buy a car that they can't really afford. So let's lease it instead. But that also drives availability of used cars."

Panel 1: Consumer advocate highlights race-to-the-bottom competition among financing companies, says "Car dealers typically sell financing and they kind of sell cars on the side." John Van Alst from the National Consumer Law Center explained the profitability of add-on products to dealers: "but dealers say somewhere around $1,100-$1,500 per unit, per car in profits on the F&I side, much of which is the sale of these add-ons…I see examples where on the same day in the same dealership, one customer is charged $47 for a window etching and another customer is charged over $1,000 for window etching." Mr. Van Alst also saw serious signs of trouble on the horizon for the subprime auto financing market: "Suddenly, we've got a lot of cars coming off lease. And that's about a third of the finance market right now. Much longer terms. And these things it's not just that it's a depreciating asset. People are way upside down day one when they walk off the lot when it's 150 percent LTV. And then if you're in a 60 month, 72 month financing for a used car, there's going to be a lot – there's already a lot of negative equity walking around. But going forward, I think it's going to matter both for the auto market and for us in general. There's going to be even more folks coming in with either a car that doesn't run anymore, that there's a huge amount of negative equity or even if it does still run but not very well. When you have a 60 month, 72 month loan and a 150 fifty percent LTV and a 20 percent interest rate, that's going to be bad. Yeah, it's going to be troublesome."

Mr. Van Alst also said these problems do not stem from the availability of credit: "This isn't a result of the fact that credit's available. This is a result of the fact that the competition for that credit is competition for dealers. So all the incentives are unfortunately bad incentives for the consumer and ultimately for a lot of the finance companies as well. You know, the availability of credit would be great if we had a market where it's people competing for the consumer's business in a fair and transparent manner, but that's unfortunately not what we're looking at right now."

Panel 1: Pricing loans to legal limit instead of risk. Panelists related how many subprime lenders do not set loan interest rates based on risk, but instead on the maximum rate allowable under the state usury law. "Look at how low interest rates actually are, how low the cost of funds are right now, the average interest rate on a used car for a subprime is 15 percent for subprime, 20 percent for deep subprime. Much of this is not risk-based pricing. It's truly opportunity based pricing. We've seen a lot of finance companies that what they do is just max out whatever the usury rate is in their state and that's what they're charging. That has huge implications, even if we don't see an increase in defaults, in terms of what that does to consumers, in terms of negative equity when they try to buy another car in terms of what it costs them day-to-day."

Panel 2: Harms to consumers from bad auto loans are long-lasting. Panelist Shanna Tallarico of New York Legal Assistance Group identified how problems stemming from default and repossession can affect borrowers for many years: "Sometimes the suits are fifteen, ten, twenty thousand dollars. And that kind of money to a person who is living paycheck-to-paycheck is crushing." She added: "then there's the effects on the credit report. And before that, it used to affect people's job prospects. Now in New York City that that has changed [with city laws regarding job screening]. For instance, I have a client right now who … just wants this over with because she wants to move and she has this trade line on her credit report. And she can't get out of her apartment and get a new apartment because the landlord wants three months up front because of this debt. So I think when someone is low-income or moderate-income, the length of which these problems can haunt them is like is the pain point. So it's like a lot of pain over a long period of time."

Panel 2: Municipal and state regulators use flexibility in policy interventions. Amit Bagga and Brad McCormick of the New York City Department of Consumer Affairs discussed that while their department is pre-empted by state law from regulating financing terms, they are able to use licensing requirements to impose consumer protection requirements on dealers. In addition, the department is considering, and in the process of legislative proposal, a bill that will be an 11 point/provision plan that will help deal with the issue of predatory lending. Key provisions include:

- Putting a dollar cap on the amount of kickbacks that dealerships can take from finance companies in order to disincentivize the dealer from selling deals that harm consumers.

- Prohibiting conditional sales to stop yo-yo scams. In these scams, dealers complete the transaction, promising a final interest rate to be filled in a week later – the interest rate then ends up being much higher than promised.

Keynote: Former AG Gansler discusses AG cooperation with CFPB. Former Maryland Attorney General Doug Gansler provided insight into the mechanics of the coordination between federal and state consumer protection enforcers: "So the CFPB and the state AGs literally have a portal that shares information. Twenty-eight states actively use it. The rest are encouraged to use it. And so each, whether you're Republican or Democrat, west, east, north, south, whatever you want, the engine of every state AG's office is the Consumer Protection Division. So the Consumer Protection Chiefs have a call all the time. They do multi-states together. They just had a conference a week ago Monday here in D.C. They get together and talk about issues. The CFPB is part of that conversation, whether there's someone on the call. Often there's direct communication between the two. And they'll often decide one will take a lead on a case and the state AG takes the lead and the CFPB will shadow it or vice versa. Often, they'll come in at the end and sort of have a joint resolution to a particular problem that has concurrent jurisdiction. How that will play out over time is anybody's guess. I mean, the CFPB is a relatively new agency. I mean, you go to RAGA conferences and they talk about how there shouldn't be a CFPB. It went on for like an hour talking about how there shouldn't be a CFPB. And Travis is not going to happen. The focus probably should be on reforming and how they want to reform it. But they talk about getting rid of it. It's here to stay. But as I said, they're still trying to flex their muscles. The CFPB is still trying to figure out who they are and what they are. I remember when I first started at my law firm a year ago, we were meeting once and we said, well, the CFPB doesn't have jurisdiction to do that. If that's your defense, you're in trouble because they think they have jurisdiction to do most anything. And so, they're still sort of figuring out who they are as an organization."