Road to Nowhere: Car Dealer Interest Rate Markups Lead to Higher Interest Rates, Not Discounts

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For the vast majority of car loan borrowers, car dealer interest rate mark ups make their loans unnecessarily more expensive than if a flat fee compensation system were in place. This is the finding of a review of recent industry data by the Center for Responsible Lending.

In a recent study, Charles River Associates suggested that if the CFPB required lenders to pay dealers through a flat rate compensation system, the cost to borrowers would outweigh the benefits of eliminating discriminatory impact. However, a closer review of the data and the assumptions that Charles River Associates used to make that claim reveal that if lenders did move to a flat rate compensation system borrowers would overwhelmingly benefit.

Background

A common practice in the auto lending market is interest rate markup. Car dealers have the ability to increase the interest rate on car loans above that for which the borrower qualifies and keep some or all of the difference as compensation. The dealers' incentive is to add as much to the interest rate as possible to maximize their compensation – reducing the additional interest rate charges is not a 'gift' to borrowers.

Lenders may limit the amount of interest that can be added, most lenders currently allow dealers to add as much as 2.5% to the interest rate. The amount of the markup is not disclosed to the consumer, but is wrapped up into the overall interest rate. In essence, dealers choose how much to pay themselves, borrower by borrower.

Dealer interest rate markup has a lengthy history of unfair and discriminatory impact. African American and Latino borrowers have historically been shown to pay more than their similarly situated white counterparts, and recent settlements show that Asian/Pacific Islander borrowers are also adversely impacted. The Consumer Financial Protection Bureau (CFPB) and the Department of Justice (DOJ) have recently entered into four public settlements with lenders totaling more than $150 million in restitution and fines to settle claims of discrimination.

Incidentally, it is worth noting that while the CFPB has indicated that flat fees are the surest way to minimize fair lending risk, their recent settlements with major auto lenders still allow dealers a limited amount of markup.

The industry also compares interest rate markup to the profit margin added to other retail products. This is a false comparison - credit is different than any other retail products because the price of the product changes from person to person. In a retail setting, the price for the product is marked and is the same for every customer who shops at that store. With credit, however, risk-based pricing allows a lender to set an interest rate that compensates the lender for the perceived credit risk the borrower presents. But when dealers tack on additional amounts to compensate themselves it is not related to credit risk.

The add-on interest is hidden from the consumer who assumes, inaccurately, the rate is based on their risk profile. Surveys show that two-thirds of Americans have no idea that the dealer is adding to the interest rate for compensation.[1] The Charles River study also fails to mention that a similar compensation system that existed in mortgage lending was banned in the Dodd-Frank Wall Street Reform law. Currently, car lending is the only form of consumer lending that allows this form of compensation.

In previous reports, we have shown that dealer interest rate markup has long been found to lead to unfair and discriminatory impact, and that shifting to a different compensation model would substantially reduce or eliminate that unfairness and discrimination.

In this piece, we explore whether the dealer interest rate markup model actually leads to "discounts" or whether consumers would be financially better off under a different system. Our analysis shows that consumers would indeed be better off under a different system.

Industry Data on Dealer Interest Rate Markup vs. Flat Fee Compensation

Industry Report

The American Financial Services Association (AFSA) commissioned a report from Charles River Associates issued in November, 2014.[2] The report was designed to criticize the method the Consumer Financial Protection Bureau (CFPB) uses to determine whether racial disparities exist in car lending.[3] For the report, Charles River Associates used individual contract data from AFSA lender members. The dataset used consists of 8.2 million new and used vehicle contracts originated during 2012 and 2013.

Charles River Associates provided data on the average amount of interest rate markup consumers paid broken down in to several categories. In one part of their analysis, the authors looked at how consumers' interest rates would change if the industry moved from the current interest rate markup model to a flat fee model.[4]

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[1] Delvin Davis, *Non-Negotiable: Negotiation Doesn't Help African Americans and Latinos on Dealer-Financed Car Loans,* Center for Responsible Lending (January 2014), found at: http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/CRL-Auto-Non-Neg-Report.pdf

[2] Arthur P. Baines and Dr. Marsha J. Courchane, *Fair Lending:Implications for the Indirect Auto Finance Market*, Charles River Associates (November 19, 2014) found at: http://www.crai.com/sites/default/files/publications/Fair-Lending-Implications-for-the-Indirect-Auto-Finance-Market.pdf

[3] A full explanation of that method can be found at: http://www.consumerfinance.gov/reports/using-publicly-available-information-to-proxy-for-unidentified-race-and-ethnicity/

[4] Baines and Courchane, 82.

For this analysis, the authors excluded what are known in the industry as “subvented” loans. These are loans that are offered at below market interest rates as an incentive to get consumers to the dealer (i.e., 0% interest loans). Because the manufacturer is paying to buy the interest rate down below market rates, the manufacturer does not then want the dealer to increase the rate for compensation. As such, the dealer is only paid flat fee compensation.

The remaining loans in the dataset include some level of markup or, in some cases, no markup at all. Charles River Associates assumed that the amount of revenue collected through interest rate markup would remain the same. Charles River Associates then allocated that revenue equally across the remaining loans and adjusted the interest rate on those loans to reflect the change in revenue allocation.[5]

For example, Charles River assumes here that if the buy rate for two loans was 4%, and if one borrower in the dataset received a loan at 4% that included no interest rate markup and another borrower received a loan at 6% with 2% of the interest rate being markup, then changing to a flat fee model would mean that both borrowers would pay the equivalent of 5% interest.

Data Show Most Consumers Would Pay Lower Interest Rates

The report shows that most borrowers would see a decrease in their interest rates if the industry moved to a flat fee model. Among borrowers who had their loans marked up, 71.5% of them would have paid a lower interest rate. Overall, 55% of consumers would pay a lower interest rate in a flat fee compensation system.

This data is significant because it shows that most borrowers would benefit from a shift to a flat fee system. However, if we take into account why the vast majority of consumers who paid little or no markup were not charged the full markup, then it is highly unlikely that those identified as "paying more" in the Charles River Associates analysis would actually do so. Taking this into account, the vast majority -- if not all -- consumers would fare better under a flat fee system.

Those who did not pay a markup or paid a small amount of markup likely had a competing credit offer in hand. If the consumer has a competing offer, and the dealer cannot meet or beat that offer, then the consumer will simply accept the less expensive competing offer. It is highly unlikely that consumers who did not pay a markup will “pay more”, but will simply choose to finance through a different source instead of the dealer.

The Charles River analysis also assumes that dealers would not work with lenders to reduce the interest rate to match a competing offer. Moving to flat fee compensation would not prohibit lenders from making interest rate reductions. Lenders have an interest in making the loan, and as such are likely to engage in negotiations to lower the interest rate to meet the competing offer. However, flat fee

[5] *Id.*

compensation would remove the incentive for the dealer to pad the interest rate with as much compensation as possible.

In our analysis of the industry report, we took the Charles River Associates assumptions at face value. Even using those assumptions, which clearly benefit the industry, we see potential benefit for consumers if the industry did indeed move to a flat fee compensation system. However, we believe that moving to a flat fee system would increase transparency in the market and allow competitive forces to better serve the consumer. As such, the market would likely react in ways that cannot be predicted through this data alone and differently than Charles River Associates assume in their report. We do believe that increased transparency and competition would move the market to provide better pricing for many consumers and ensure that dealers receive adequate compensation for providing credit options.

Additional data in the Charles River report also support the conclusion that few would pay substantially more in interest. The report showed that 65% of those who did not pay an interest rate markup had a credit score above 680, and 53% had a credit score above 720. This suggests that those who would have the most choices in financing, which are those with higher credit scores, are able to leverage those multiple options into lower rates. Those with lower credit scores are more likely to pay an interest rate markup of some kind, and likely to pay a higher markup because they have fewer lending options.

The data also show that, while most borrowers save, borrowers of color are more likely to save money than white borrowers if the industry shifted to flat fees instead of discretionary interest rate markups. Again, excluding those contracts without a dealer markup included, the data show:

- The average African American borrower would save $267,
- The average Hispanic borrower would save $278, and
- The average Asian borrower would save $270, while
- The average white borrower would save $229.[6]

Conclusion

While the industry continues to try to cast dealer interest rate markups as a kind of discount program, their own data shows that, for most consumers, markup leads to unnecessarily higher interest rates. The data also indicate that those consumers the industry would point to as a reason to maintain the interest rate markup system – those who would “pay more” under a flat fee system – would very likely receive the same interest rates they get now.

The long and ongoing history of discrimination associated with dealer interest rate markup, coupled with this analysis, show that consumers would be better off if dealer interest rate markup ceased to exist.

[6] *Id.* at 132.

At the very least, this should give pause to those in Congress supporting or considering support for bills like H.R. 1737, which are designed to stop the CFPB's efforts to root out discrimination in car lending. Seeing that in many cases, dealers already get paid through flat fee compensation, moving entirely to that model would not be disruptive to the industry. For consumers, that change would likely mean lower interest rates and more assurance that the interest rate offered is what they deserve.