



**UNDER THE HOOD:
Auto Loan Interest Rate Hikes Inflate
Consumer Costs and Loan Losses**

EXECUTIVE SUMMARY

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Automobiles are the most common nonfinancial assets held by American households. For most American households, car ownership is not a luxury, but a prerequisite to opportunity. Cars not only provide transportation, but also options for where to work and live, and how we interact with our community. As a result, both the affordability and sustainability of auto financing are central concerns for American families.

A car purchase can be a complicated endeavor. Negotiations on the sales price, trade-in value, and financing are all separate transactions. Any of these transactions can have a significant influence on the vehicle’s overall cost. Unfortunately, not all of these transactions are transparent to consumers. In particular, on loans made through the dealership, the dealer can markup the interest rate above what the consumer’s credit would qualify for. This interest rate markup, also known as “dealer reserve” or “dealer participation,” is described by dealers as the way they are compensated for time spent putting a financing deal together. However, since consumers usually do not know what they can actually qualify for, the markup is often a hidden cost to the consumer.

This report takes a look at markups, evaluates how they are used, and identifies their potential consequences. **Our research concludes that interest rate markups from dealerships lead to more expensive loans and higher odds for default and repossession for subprime borrowers.** Based on an analysis of automobile asset-backed securities (ABS), data from 25 auto finance companies representing a combined 1.7 million accounts at year-end 2009, and other information from industry sources, we find the following:

Finding 1: Consumers who financed cars through a dealership will pay over \$25.8 billion in interest rate markups over the lives of their loans. Analyzing 2009 auto industry data, the average rate markup was \$714 per consumer with an average rate markup of 2.47 percentage points. Even though the number of vehicle sales declined by 20% from 2007 to 2009, total markup volume increased 24% during this period (from \$20.8B to \$25.8B) largely due to an increase in the level of rate markups on used vehicle sales.

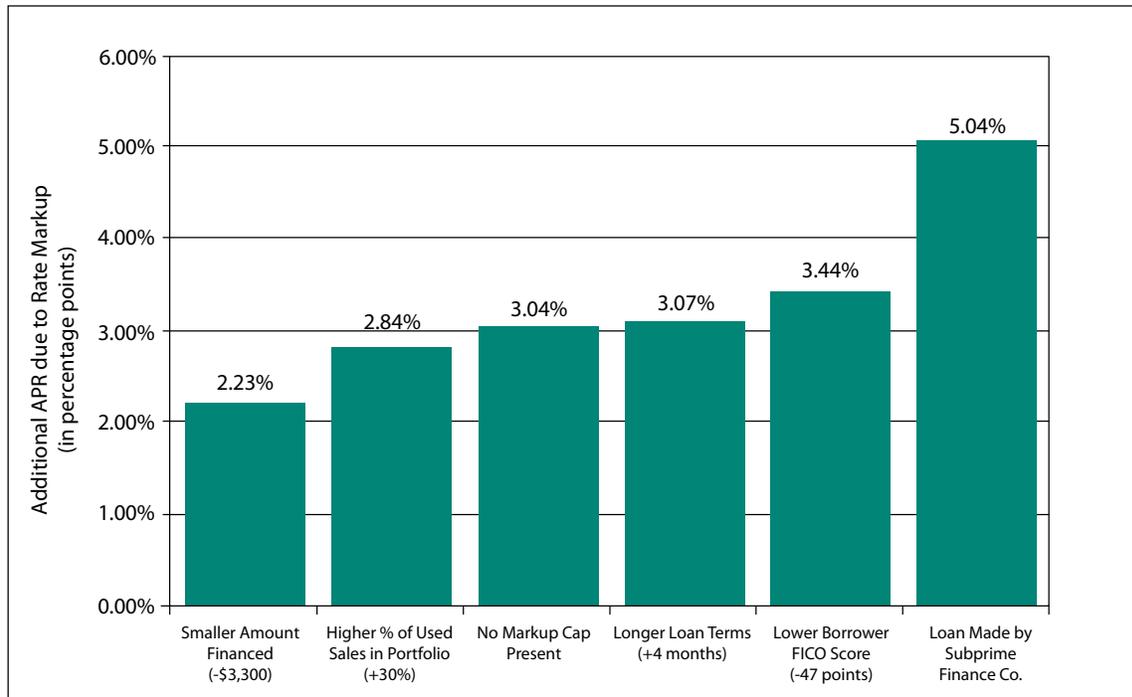
Figure 1: Total and Average U.S. Markup Volume 2009

	New Vehicles	Used Vehicles	Total Vehicles
2009 Total Rate Markup Volume	\$4.1 Billion	\$21.7 Billion	\$25.8 Billion
Average Rate Markup 2009	1.01%	2.91%	2.47%
Average Markup Per Loan 2009	\$494	\$780	\$714
Dealer Gross Profit Per Retail Sale 2009	\$1,301	\$1,721	\$1,461

Sources: Data derived from CNW Marketing Research (sales data for dealer financed purchases, excluding leases), 2010 National Auto Finance Automotive Survey (dealer markup data), and YTD 2009 NADA Average Dealership Profile (gross dealer profit). Average markup figures assume a rate markup occurs on every dealer-financed sale, leading to more conservative averages.

Finding 2: Dealers tend to mark up interest rates more for borrowers with weaker credit. As shown in the chart below, loans made by subprime finance companies have higher rate markups, and rate markups also increase with lower borrower credit scores. In addition, larger rate markups occur on loans with longer maturities, loans for used vehicles, and when smaller amounts are financed. These findings suggest that dealers may use certain borrower or loan characteristics as a way to identify people who would be vulnerable targets for increased rate markups.

Figure 2: Change in Amount of Rate Markup Given Changes in Loan Conditions



Figures are based on results from regression models using auto ABS data. The change in each category is assuming the increase of one standard deviation in the independent variable. Note that the markup increase of each variable does not have a cumulative effect if multiple conditions exist on one loan.

Lenders may use self-imposed markup caps to control pricing. However, finance companies that lend more to subprime borrowers are not likely to have rate markup caps at all. Still, even the typical markup cap can still allow for nearly \$1,700 in extra interest payments over the life of a typical new car loan.

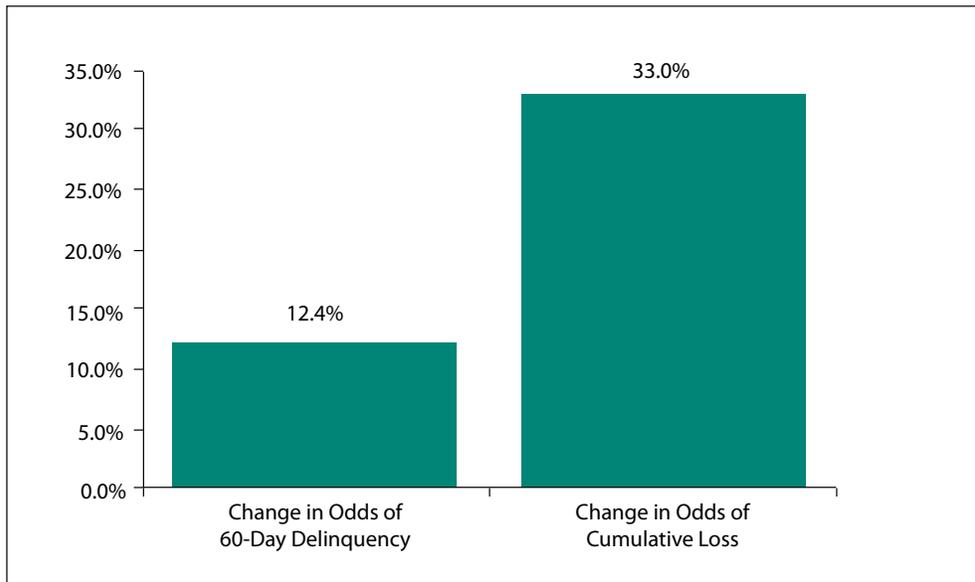
Figure 3: Example of Potential Extra Interest Payments Due to Rate Markup

	New Cars	Used Cars
Amount Financed	\$24,500	\$17,500
APR Consumer Qualified For	4.0%	8.0%
APR + 2.5% Rate Markup	6.5%	10.5%
Loan Term in Months	60	60
Potential Extra Interest Payments Resulting from Rate Markup	\$1,690	\$1,278

Note that the average markup amount is \$714 per vehicle, notably more conservative than the totals in this example. This is largely due to the fact that the average amount includes loans that do not have a rate markup, which brings down the average.

Finding 3: Rate markups are a strong driver of default and repossession among subprime borrowers. Markups have a strong association with 60-day delinquency and cumulative loss rates (what the lender has to write off due to repossessions) for finance companies that target low-FICO borrowers. These results occur for loans performing within the same macroeconomic environment, discounting the notion that the economy is the sole reason for recent loan defaults. Rate markup increases the odds of delinquency and cumulative loss for subprime borrowers by 12.4% and 33% respectively.

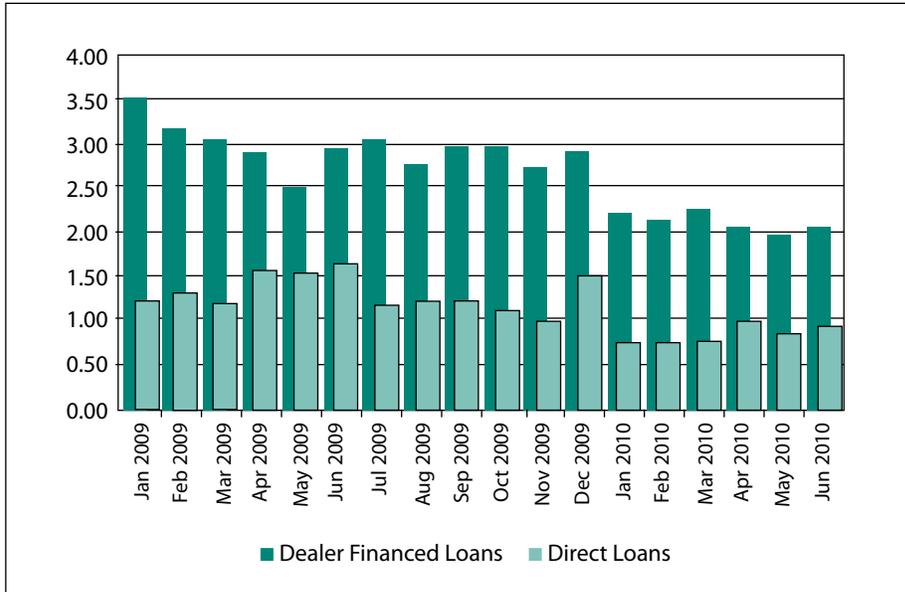
Figure 4: Increase in Odds of Default Due to Rate Markups for Subprime Finance Companies



Odds ratios based on coefficients from linear regression models using auto ABS data. Changes in odds are based on an increase of one standard deviation of rate markup for finance companies (4.55%). Regression model for non-finance companies produced results that were not significant.

Interestingly, even with the prevalence of markup caps and other promotional incentives that would lower interest rates, repossession rates for dealer-financed loans consistently outpace those of their direct lending counterparts. Dealers have asserted that the rise in auto repossessions, which peaked at 2 million units in 2008, is mainly caused by larger economic factors outside the dealership's control. But given that direct and indirect lenders operate in the same macroeconomic environment, this argument does not entirely explain why repossession rates for dealer financing have been nearly double the rates of direct auto lending in recent history.

Figure 5: Direct vs. Dealer-Financed Repossession Rates (Repos per 1,000 Loans)



Source: American Bankers Association Consumer Credit Delinquency Bulletin. Figures are seasonally adjusted.

DISCUSSION

With declining sales and narrowing margins on profits from car sales, dealerships have grown increasingly dependent on profit from their finance and insurance (F&I) departments which generate revenue through the financing on the car and selling ancillary products. This pressure on the F&I department can lead to staff taking advantage of the lack of transparency in auto financing, and translating it into profit.

Our analysis shows that rate markups vary widely depending on the terms of the loan. Borrowers have little or no bargaining power to combat this effect and can easily be pushed into a loan that costs more than is required by their credit history or the characteristics of the loan.

Survey data confirms that the majority of consumers are generally unaware that dealers can markup rates without their consent (79%), and ultimately unaware of what the APR is on their loan (61%). Industry attorneys advise F&I staff not to tell consumers that their rate is the “best rate they qualify for,” as that could legally be interpreted as deceptive, but instead reiterate “this is the rate that is available.”

Interest rate markups also create the potential for discriminatory outcomes. In the past decade, eleven major lenders that participate in indirect financing have settled class action lawsuits alleging racial discrimination in how markups were assigned to their loans. Loan-level data showed that African-Americans and Latinos disproportionately received interest rate markups more frequently and to a greater degree than their similarly-situated white counterparts.

Dealers argue that the rate markups are legitimate compensation for a valuable service the F&I office provides. However, this does not explain why dealers charge for this service to some customers and not others, nor what methods they use to determine how much to charge. The lack of disclosure also does not allow consumers to determine how much a dealer's services are worth to them. According to the latest industry data, the average customer spends 45 minutes with the F&I department, and only 27 minutes if taking a test drive. With the average rate markup at \$714, dealership staff are effectively billing consumers from \$952 to \$1,587 per hour to finance the vehicle.

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Interest rate markups closely parallel how yield spread premiums operated in the subprime mortgage industry. In that case, yield spread premiums created an incentive for mortgage brokers to structure loan financing toward the upper limits of what borrowers could handle. As a result, many mortgages were not affordable long-term, and resulted in higher foreclosure rates. Further, African-American and Latino borrowers were more likely to receive loans that included yield spread premiums compared with similarly situated white borrowers. Recognizing this, the Federal Reserve recently approved a rule to prohibit the practice altogether.

Likewise, delinquencies and repossessions resulting from unsustainable auto loans can have serious consequences for consumers. Therefore, if rate markups from auto dealers disproportionately contribute to loss and delinquency, then the practice should be reined in as well.

To avoid higher costs, delinquencies, and losses related to interest rate markups, we recommend completely divorcing dealer compensation from the interest rate on vehicle financing. Instead, a flat fee is a viable alternative for compensating dealers—this adds transparency and fairness while eliminating any incentive to drive up rates at the detriment of loan sustainability.

About the Center for Responsible Lending

The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

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