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Before the NY Senate Banks Committee
On Predatory Practices in Subprime Auto Lending

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Thank you for the opportunity to submit written testimony for today's hearing on predatory practices in the subprime auto lending market.

The Center for Responsible Lending (CRL) is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, a nonprofit community development financial institution. For thirty years, Self-Help has focused on creating asset-building opportunities for low-income, rural, women-headed, and minority families, primarily through financing safe, affordable home loans and small business loans. In total, Self-Help has provided $6.4 billion in financing to 87,000 homebuyers, small businesses and nonprofit organizations and serves more than 80,000 mostly low-income families through 30 retail credit union branches in North Carolina, California, and Chicago.

Cars are the most common nonfinancial asset held by American families, and for some families, their most significant asset. Cars have become a necessity for U.S. households, with more than 85% of the U.S. workforce using an automobile to commute to work.[1] Car ownership is no longer a luxury but is a prerequisite to economic opportunity. The need for a car is particularly acute among low- and moderate-income families and Latino and African American families who increasingly live farther from jobs than white families.[2] It is no wonder, then, that TransUnion reported that consumers consistently make paying their auto loans the top priority, ahead of paying their housing or credit card bills.[3]

Lending plays a critical role in U.S. households' access to cars. Total car loan debt is second only to mortgage loan debt, and there are more auto loans than mortgages in the United States.[4] By the end of 2014, U.S. households owed approximately $956 billion in outstanding auto loans, an amount that has

[1] Brian McKenzie, U.S. Census Bureau, *Modes Less Traveled—Bicycling and Walking to Work in the United States: 2008-2012*, *available at* http://www.census.gov/hhes/commuting/files/2014/acs-25.pdf.
[2] *See* Elizabeth Kneebone and Natalie Holmes, *The Growing Distance Between People and Jobs in Metropolitan America* (Mar. 2015), *available at* http://www.brookings.edu/~/media/research/files/reports/2015/03/24-job-proximity/srvy_jobsproximity.pdf.
[3] *See* Les Christie, *Borrowers Paying Mortgage Over Credit Cards Again*, CNNMoney (Mar. 29, 2014), http://money.cnn.com/2014/03/19/real_estate/mortgage-payments/.
[4] Phil Izzo, *More Car Loans Than Mortgages in U.S.*, Wall Street Journal, Aug. 14, 2013, *available* at: http://blogs.wsj.com/economics/2013/08/14/more-car-loans-than-mortgages-in-u-s/.

been increasing steadily for more than three years.[5] New auto loan originations are at volumes not seen since 2005.[6]

Unfortunately, auto finance is marked by a noted lack of regulation and transparency. Many predatory and abusive practices have been allowed to thrive, leading to unnecessarily expensive and likely unsustainable loans, particularly for those least able to afford it. Predatory practices place people with subprime credit at particular risk because fewer direct auto financing options are available to them. Similarly, our research shows African American and Latino borrowers receive higher interest rates on car loans from dealers than similarly situated white borrowers and are more likely to receive misleading information in the car buying process, resulting in higher priced cars and loans.[7] Many of these abusive practices in auto lending, including in the subprime space, are not new – they have festered for some time. Abuses pertaining to auto dealer interest rate markups, yo-yo scams, loan packing, and by Buy Here Pay Here dealers have been the subject of scores of lawsuits and enforcement actions by state and federal regulators.

We are also seeing practices in the auto lending market that mirror those in the mortgage market prior to the housing crisis. Risk layering – combining several practices that increase the risk of delinquency or default – is increasing. The size and length of loans continues to grow. Delinquency and default rates are climbing in auto lending while falling for other forms of credit. One lesson we hopefully learned from the crisis is to take heed of troubling data and act to prevent needless losses and harms to consumers, not wait for them to occur. We believe that eliminating abusive practices now could prevent avoidable economic harm to New York consumers.

I will first address subprime auto lending more generally and then turn to a brief discussion of the abusive practices.

1. **Subprime Auto Lending**

The auto finance market has grown significantly in the past few years, with much of this growth due to the rise in subprime auto lending. Since 2009, lending to subprime consumers has more than doubled, while lending to prime consumers has only increased by about half.[8] As of the end of 2014, loans to consumers with below prime credit comprised approximately 38.8% of open accounts, totaling approximately $335 billion.[9] Subprime auto loan securitization issuances stood at $21.8 billion in 2014,

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[5] *See* Fed. Res. Bank of N.Y., *Quarterly Report on Household Debt and Credit* (Feb. 2015), *available at* http://www.newyorkfed.org/householdcredit/2014-q4/data/pdf/HHDC_2014Q4.pdf; Andrew Haughwout, et al., "Just Released: Looking Under the Hood of the Subprime Auto Lending Market", *Liberty Street Economics* (Aug. 14 2014), http://libertystreeteconomics.newyorkfed.org/2014/08/just-released-looking-under-the-hood-of-the-subprime-auto-lending-market.html.
[6] *See* Fed. Res. Bank of N.Y., *Quarterly Report on Household Debt and Credit* (Nov. 2014), *available at* http://www.newyorkfed.org/householdcredit/2014-q3/data/pdf/HHDC_2014Q3.pdf.
[7] Delvin Davis, *Non-Negotiable: Negotiation Doesn't Help African Americans and Latinos on Dealer-Financed Car Loans* (Jan. 2014), *available at* http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/CRL-Auto-Non-Neg-Report.pdf.
[8] Andrew Haughwout, et al., "Just Released: Looking Under the Hood of the Subprime Auto Lending Market", *Liberty Street Economics* (Aug. 14 2014), http://libertystreeteconomics.newyorkfed.org/2014/08/just-released-looking-under-the-hood-of-the-subprime-auto-lending-market.html.
[9] Experian Automotive, *State of the Automotive Finance Market, Fourth Quarter 2014*, Melinda Zabritski.

the most since 2006.[10] The growth in the subprime segment certainly raises concerns about inadequate and potentially predatory underwriting and lending practices, as well as concerns that those practices risk causing problems in the larger auto market.

Our research found that auto repossession rates have climbed significantly over the past year or so, increasing more than 70% from the third quarter of 2013 to the same period in 2014.[11] Delinquency rates have also been increasing in many markets, though nationally, delinquency rates appear to be flat.[12] However, the speed of repossession can create an environment where a spike in the repossession rate can occur without a parallel increase in seriously delinquent accounts, as lenders can accelerate repossession at an earlier point in delinquency if they believe the collateral is under threat. Some in the industry argue that auto delinquency rates are lower than in the mortgage market before and during the mortgage meltdown. However, the speed of repossessions (48 days)[13] versus foreclosures (577 days)[14] distorts the data. If it took as long to repossess a car as it takes to foreclose on a house, the repossession rate would be 7.41 percent, 12 times higher than the 0.62 percent Experian reports.[15]

We have also found that lenders are loosening underwriting standards, thus increasing the risk of defaults, particularly for subprime auto loans.[16] A measure of the loosening standards is rising loan-to-value (LTV) ratios and lengthening loan terms, both of which are more pronounced in the subprime market.[17] An extended loan term makes the monthly payment appear more affordable to the borrower in the short-term, but in combination with the higher LTV, increases the risk that the borrower will be unable to repay. Indeed, data from year end 2014 shows that loans with 73-84 month terms increased 19% and 29% for new and used cars, respectively, and loan amounts rose to all-time highs.[18] Additionally, LTV ratios and loan terms on subprime new car loans are significantly higher than the industry average for prime loans.[19] Finally, LTV ratios above 100%, which lenders routinely allow dealers to make, allow the dealer to finance add-ons or “negative equity”, which is the amount that is still owed when a trade-in vehicle is worth less than the outstanding balance of the loan on trade-in.

As I discuss below, loosening underwriting is only one piece of the puzzle in subprime auto lending. Other practices shown to be abusive further increase the cost of an auto loan, and subsequently, the risk

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[10] Jody Shenn, *Moody’s deRitis Sees Inflection Points for Risks in Auto Lending*, Bloomberg (Mar. 4, 2015), *available at* http://www.bloomberg.com/news/articles/2015-03-04/moody-s-deritis-sees-inflection-point-for-risks-in-auto-lending.

[11] Center for Responsible Lending, *“Reckless Driving”: Implications of Recent Subprime Auto Finance Growth* (Jan. 2015), *available at* http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/recklessdriving_implications_subprime_autofinance_growth.pdf.

[12] *Id.*

[13] CNW Marketing Research, *Document 1805: Repossession Data*.

[14] RealtyTrac, U.S. Foreclosure Market Report, 2Q 2014.

[15] Center for Responsible Lending, *“Reckless Driving”: Implications of Recent Subprime Auto Finance Growth* (Jan. 2015), *available at* http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/recklessdriving_implications_subprime_autofinance_growth.pdf.

[16] *Id.*

[17] Experian Automotive, *State of the Automotive Finance Market, Fourth Quarter 2014*, Melinda Zabritski.

[18] *Id.*

[19] Center for Responsible Lending, *“Reckless Driving”: Implications of Recent Subprime Auto Finance Growth* (Jan. 2015), *available at* http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/recklessdriving_implications_subprime_autofinance_growth.pdf.

of default. Because some of these practices, such as dealer markup and loan packing, have been shown to disproportionately affect borrowers of color, they are of particular concern.

2. **Dealer Interest Rate Markups**

The auto finance market has a wide spectrum of players. These actors include banks, credit unions, captive finance companies, specialty finance companies, and Buy Here Pay Here (BHPH) dealers. The vast majority of consumers (approximately 80%) who use financing to purchase an automobile finance the purchase through the dealer, where the dealer extends credit, usually through a retail installment contract, and then quickly sells the contract to a third-party financial institution.[20] This arrangement is known as "indirect financing."

In indirect loans, the interest rate that the financial institution is willing to accept is called the "buy rate." Lenders also usually allow the dealer to increase the interest rate and keep some or all of the difference between the buy rate and the rate offered to the consumer. This amount is often called the "dealer markup."

The dealer's ability to mark up the interest rate for its own gain creates a perverse incentive for the dealer to push the consumer into the most favorable loan for the dealer instead of a loan that offers the lowest cost to the consumer. New Yorkers who purchased cars in 2009 paid $1.58 billion in additional interest due to the dealer's markup of the rate.[21] This is not to say that dealers should not receive compensation for the work they do on the financing, when this amount of money is at stake we should be certain that the compensation is being gained fairly.

Data show that rate markups are higher for used cars and are significantly correlated with subprime lenders and with higher odds of default and repossession.[22] In addition, this practice has been the subject of several lawsuits and regulatory actions over the past two decades, which provide strong evidence that borrowers of color paid disproportionately higher interest rates than similarly-situated white borrowers.

3. **Yo-Yo Scams**

A yo-yo scam occurs when a dealer allows a buyer to believe that the financing arrangement is final, or as good as final, and lets the buyer leave the dealership with a car. Days, weeks, or months later, the dealer then requires the buyer to return to the lot to negotiate a new (and more expensive) deal. The dealer is able to do this by asserting the ability to cancel the deal because the dealer decides none of the offers from lenders to purchase the finance contract are acceptable. Yo-yo scams are possible because of the practice of "spot delivery" where dealers allow consumers to drive off the lot with the car even when the financing is not final.

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[20] Delvin Davis, *Auto Loans: The State of Lending in America & Its Impact on U.S. Households* (Dec. 2012), *available at* http://www.responsiblelending.org/state-of-lending/reports/4-Auto-Loans.pdf.
[21] *See* "Rate Markup by State" http://www.responsiblelending.org/other-consumer-loans/auto-financing/tools-resources/rate-markup-volume-by-state.html.
[22] Delvin Davis and Josh Frank, *Under the Hood: Auto Loan Interest Rate Hikes Inflate Consumer Costs and Loan Losses* (Apr. 2011), *available at* http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/Under-the-Hood-Auto-Dealer-Rate-Markups.pdf.

The dealer may also refuse to return a consumer's trade-in or down payment, which increases the leverage against the consumer to enter into a less favorable contract. In addition, the dealer may threaten to charge fees for the use of the vehicle or threaten prosecution for auto theft if the consumer does not return the car to the dealer. It is thus understandable how many consumers agree to new terms.

Research shows that low-income and subprime borrowers are more subject to yo-yo scams.[23] Additionally, consumers ensnared in yo-yo scams receive interest rates 5 percentage points higher than those that are not caught up in such scams.[24]

4. **Loan Packing**

Loan packing occurs when the dealer adds any number of ancillary products, such as extended warranties, security systems, insurance products, and vehicle upgrades and accessories, to the loan amount while hiding or misrepresenting the practice, terms, or value of these products. These products are often sold bundled as packages, and they are advertised in terms of the impact on monthly payments rather than the overall cost of the car. Marketing ancillary products based on their monthly payment instead of the overall cost makes expensive items seem more affordable and distracts the consumer's attention away from the total cost of the deal. Add-on products are becoming increasingly popular as a revenue stream since profit margins on car sales are declining and interest rate markups are under intense regulatory scrutiny.[25]

African American and low-income buyers disproportionately receive overpriced ancillary products.[26] Additionally, research shows that Latino and African American buyers are more likely to be told that optional add-on products are in fact mandatory.[27] For all consumers, loan packing contributes to higher LTV ratios, negative equity and excessive debt because the cost of the products is added on to the sales price and financed into the loan being arranged by the dealer.

5. **Buy Here Pay Here Dealers**

[23] *See* Delvin Davis and Josh Frank, *Car Trouble: Predatory Auto Loans Burden North Carolina Consumers* (Apr. 2009), *available at* http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/car-trouble.pdf; Delvin Davis, *Deal or No Deal: How Yo-Yo Scams Right the Game Against Car Buyers* (Apr. 2012), *available at* http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/Deal-or-No-Deal-How-Yo-Yo-Scams-Rig-the-Game.pdf.

[24] Delvin Davis, *Deal or No Deal: How Yo-Yo Scams Right the Game Against Car Buyers* (Apr. 2012), *available at* http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/Deal-or-No-Deal-How-Yo-Yo-Scams-Rig-the-Game.pdf.

[25] Jim Henry, *Dealership Gross Profits See Bigger Impact from F&I*, Automotive News (Apr. 15, 2015), *available at* http://www.autonews.com/article/20150415/FINANCE_AND_INSURANCE/304159998/dealership-gross-profits-see-bigger-impact-from-fi.

[26] Delvin Davis and Josh Frank, *Car Trouble: Predatory Auto Loans Burden North Carolina Consumers* (Apr. 2009), *available at* http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/car-trouble.pdf.

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

Buy Here Pay Here (BHPH) dealers are dealers that cater to subprime borrowers unable to secure financing from traditional lenders. BHPH dealers typically make, hold, and service all of the loans they finance in-house, often requiring borrowers to pay in-person at the dealership on a weekly or biweekly basis. BHPH dealers sell older used cars, often at nearly double what the dealer paid for it wholesale, and charge APRs exceeding 25%.[28]

A common predatory practice among BHPH dealers is quick repossession to recover the collateral at the first sign of delinquency. As one BHPH advisor puts it, "collections is the single most important process with the most direct effect and instant impact on whether you are successful or not as a BHPH dealer."[29] Market data shows that 1 in every 5 BHPH car loans will default.[30] As a way to enable easy repossession, BHPH dealers frequently install GPS and/or starter interrupt device, also called "Kill Switches", which allow the dealer to track the location of the car and remotely disable the ignition.[31] Media organizations have documented multiple privacy and safety concerns surrounding the use of GPS locators and kill switches.[32] After repossession, the dealer often sells the car again to a different consumer, creating a "churning" effect where the same old, yet expensive, cars are sold and resold to borrowers who have few options for affordable auto loans.

Conclusion

Abusive lending practices do not occur in isolation. The same consumer who receives a subprime interest rate with a disproportionately high markup, will likely finance several add-ons and negative equity of a trade-in, all resulting in a high LTV ratio, and stretch out the loan more than 5 or 6 years. For African American and Latino borrowers, this scenario is even more likely to occur. This kind of risk layering was a hallmark of the subprime mortgage market before the meltdown, and is important to consider when confronting abusive car lending practices.

When done responsibly, auto finance makes economic opportunity possible and sustainable. Unfortunately, a number of abusive practices in auto lending can do just the opposite by unnecessarily costing consumers billions of dollars and putting consumers at risk for losing their cars. New York is already at the forefront of addressing predatory practices in subprime auto lending, with state and city regulators taking a close look at dealer and lender practices through investigations. In addition, new programs to encourage responsible lending, such as that proposed by the New York City Department of Consumer Affairs, hold promise in creating a loan product that allows for access to affordable credit that consumers are more able to repay. A few states, including New York, are exploring limitations on the use of starter interrupt devices, and others are looking into regulations on BHPH dealers.

Regulators, legislators, and law enforcement should continue to pay attention to problems in the subprime market and should eliminate the well-known and well-documented abuses in the auto lending market highlighted here to stop increasing levels of default. Of particular focus should be those practices

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[28] Delvin Davis, *Auto Loans: The State of Lending in America & Its Impact on U.S. Households* (Dec. 2012), *available at* http://www.responsiblelending.org/state-of-lending/reports/4-Auto-Loans.pdf.

[29] Rod Heasley, *BHPH Success – Sales vs. Collection*, BHPH E-Magazine (Apr. 13, 2012), *available at* http://bhph-emagazine.com.

[30] Kenneth Shilson, *Buy Here Pay Here Industry Benchmarks/Trends 2011*. Subprime Analytics.

[31] Michael Corkery and Jessica Silver-Greenberg, *Miss a Payment? Good Luck Moving that Car*, The New York Times (Sept. 24, 2014), *available at* http://dealbook.nytimes.com/2014/09/24/miss-a-payment-good-luck-moving-that-car.

[32] John Dyer, *Banks and Car Dealerships are Using an Orwellian New Tactic on Debtors*, Vice News (Nov. 10, 2014), https://news.vice.com/article/banks-and-car-dealerships-are-using-an-orwellian-new-tactic-on-debtors.

that have a historic pattern of abuse and disproportionate impact on low-income borrowers and borrowers of color, namely dealer interest rate markups and yo-yo scams. To address increasingly unaffordable loans, regulators and legislators could consider applying consistent ability-to-repay standards for auto lending, and ensure that lenders are exercising appropriate underwriting practices.

We believe that a robust car lending market is important to New York families. In particular, making loans to those with tarnished credit or thin credit files can open doors to economic opportunities. However, the current market requires safeguards to ensure that the market is robust <u>and</u> sustainable. Abusive lending practices have no place in our credit markets.