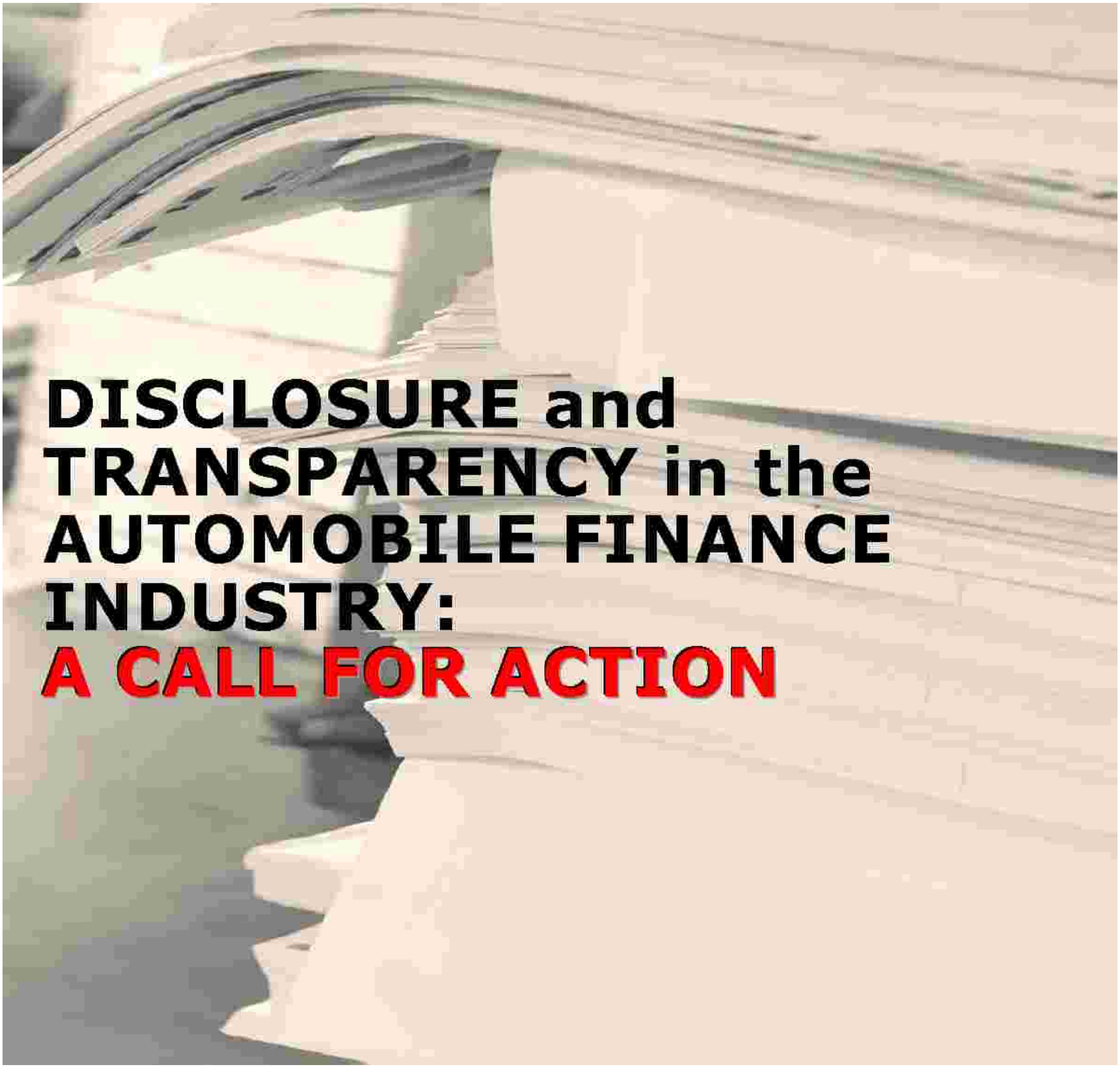

DISCLOSURE and TRANSPARENCY in the AUTOMOBILE FINANCE INDUSTRY: A CALL FOR ACTION

Carolyn Hayden, Consultant
Annie E. Casey Foundation Children and Family Fellow

Sheela Cooper, Consultant

Funded by the Annie E. Casey Foundation and produced by the
Annie E. Casey Foundation Children and Family Fellowship Network
December 2008

Disclosure and Transparency in the Automobile Industry: A Call for Action

By: Carolyn Hayden and Sheela Cooper
Layout: Devra Culver
One World Consulting Group, LLC and Opportunity Cars

One World Consulting Group, LLC promotes effective practice and policy efforts designed to increase access to safe and affordable vehicles, and access to credit at fair terms for hard working families.

Opportunity Cars is a national network of more than 150 car ownership programs operating in 34 states across the country. Opportunity Cars programs serve the private transportation needs of hard working families by providing them with affordable and reliable vehicles, low-interest automobile financing, and matched savings accounts for vehicle purchases *(see www.opportunitycars.com)*.

For additional information or free PDF download copies of this report, visit www.opportunitycars.com.

One World Consulting Group, LLC
9200 Basil Court, Suite 303
Landover, MD 20774
Phone: (301)772-1971
E-mail: info@oneworldgrpllc.com

ACKNOWLEDGEMENTS

We are grateful to The Mobility Agenda staff, especially Research Associate Jonny Finity, for their significant contribution to the concepts, knowledge development, and writing of this report.

This project would not have been possible without the Home Mortgage Disclosure Act experts and automotive industry experts named below who so generously shared their time and talents. Their willingness to contribute knowledge and support to this project is sincerely appreciated.

Calvin Bradford, President
Calvin Bradford & Associates
Williamsburg, VA

Jim Carr, Chief Operating Officer
National Community Reinvestment Coalition
Washington, D.C.

Delvin Davis, Research Analyst
Center for Responsible Lending
Durham, NC

Allen Fishbein, Adviser, Division of Consumer and Community Affairs
Board of Governors of the Federal Reserve System
Washington, D.C.
(Formerly Director of Housing and Credit Policy at The Consumer Federation)

Josh Frank, Senior Researcher
Center for Responsible Lending
Durham, NC

Dan Immergluck, Associate Professor, City and Regional Planning Program
Georgia Institute of Technology
Atlanta, GA

Mary Lobdell, Assistant Attorney General, Tacoma Section Chief
Consumer Protection Division
Tacoma, WA

Patricia McCoy, George J. & Helen M. England Professor of Law
University of Connecticut School of Law
Hartford, CT

Rosemary Shahan, President
Consumers for Auto Reliability and Safety
Sacramento, CA

Josh Silver, Vice President of Research and Policy
National Community Reinvestment Coalition
Washington, D.C.

Gregory Squires, Professor of Sociology and Public Policy and Public Administration
The George Washington University
Washington, D.C.

Corey Stone, Chief Executive Officer
Payment Reporting Builds Credit
Annapolis, MD

John Van Alst, Staff Attorney
National Consumer Law Center
Boston, MA

TABLE OF CONTENTS

I. THE ECONOMIC AND SOCIAL COST OF CREDIT TODAY

The consumer credit market has changed dramatically in the last half century, fueled largely by technological advances, deregulation, and financial innovation. As recently as 40 years ago, consumers and advocates across the United States were questioning whether credit services were equitably distributed among their communities. With the fairly recent rise of subprime lending, which includes millions of borrowers who were previously denied credit in the lending market, the question is no longer limited to whether everyone has access to credit. The collapse of the home mortgage industry, which is fueling an economic downturn of historic proportions, is instead raising questions about the fairness, social cost, and even legality of the terms at which consumer credit is available today, particularly in the subprime finance market. The U.S. economy is only beginning to experience the detrimental effects that some subprime lending practices can cause.

Automobile Finance: A Growing Crisis

In addition to instability caused by the crisis in subprime mortgage lending, there is growing concern over troubling developments in another crucial sector of the lending industry: automobile finance. Increasing rates of automobile loan default especially on subprime loans are worrying industry analysts and consumer advocates

Predatory and unethical lending patterns are another troubling issue within subprime automobile financing. For most consumers, a car or private vehicle will be one of the largest purchases of their lives, second only to a home. With limited regulation that is often not enforced, some automobile dealers and lenders including Buy Here Pay Here lots[9] are taking advantage of families and individuals that have limited options and information at their disposal, generating large profits on the sale of often unreliable and overpriced vehicles while saddling millions of consumers with high, sometimes unmanageable, levels of debt. Because no disclosure laws are currently in place regarding automobile lending, unethical lenders face few consequences for predatory lending practices. Because of

advocates have few resources to gauge patterns within the lending process to determine the existence of discriminatory or unfair lending actions.

HMDA: Lessons from the Mortgage Industry

In the 1960s and 70s, communities across the U.S. grew concerned about the connection between discriminatory lending practices by financial institutions and the continuing decline of their neighborhoods.[10] Advocates and members of civil rights groups accused banks and other commercial lenders of a practice known as

in which institutions take deposits from neighborhood residents but do not lend in those same

Yet these lenders make profits ranging from 20 percent to 50 percent on high interest subprime loans, which implies that there is room for rate reduction while still maintaining a high level of profit.[28] Subprime borrowers usually those with the fewest assets end up paying much more for the same car than prime customers. A difference of ten percentage points on a loan 18 percent for a subprime borrower versus eight percent for a prime borrower results in an additional $3,000 cost to the subprime consumer on a $10,000 vehicle financed for five years.[29]

Another characteristic of subprime automobile finance is unscrupulous and unfair lending practices. High-pressure automobile dealers may use underhanded tactics to coerce customers into accepting add-ons, higher payments, or unnecessary extended warranties.[30] Dealers will adjust the purchase price, add-on value, insurance premiums, or loan duration to maximize their commission if a customer wants to negotiate a lower interest rate. Different buyers may receive vehicles of equal value at disparate prices based solely on their ability to negotiate, or because of ruthless persistence by the dealer. A Texas study by the Consumers Union revealed that automobile add-ons cost consumers $1.1 billion every year. The additional items like extended warranties and theft protection added $99 to $5,000 per product onto the price of the vehicles purchased and increased the total interest paid by consumers over the life of the loan.[31]

lender. Neither the amount of the markup, nor the fact that this practice occurs, is ever disclosed to the borrower.[35] This practice has a particularly heavy impact on consumers because the majority of automobile sales are executed with the dealer as the original lender.[36] Typically, most vehicle buyers are entering the dealership without any pre-arranged financing and are relying on getting a loan through the dealer. The dealer is happy to oblige, and they will frequently get rate quotes from several lenders and pick the one that is most advantageous for the dealership, not the consumer.[37] The

there is no way for them to know that they may have qualified for a lower interest rate through the dealer.

Another practice that illustrates the lack of transparency to consumers is the Auto Industry Option score, a credit score available only to automobile dealers that contains information unavailable in traditional credit reports. Dealers can use either the consumer accessible Fair Isaac Corporation (FICO) score or the Auto Industry Option score (with specific information on how a borrower handled previous automobile credit) to determine financing eligibility.[38] These scores may then be used interchangeably by the dealer to obtain the most profit, and not necessarily the best interest rate for the consumer.[39]

the effects of a struggling economy, subprime borrowers (especially minorities) essentially pay twice first in direct terms of more expensive credit, and second in terms of a weaker economy overall.

Subprime lending problems not only impact subprime borrowers - there is also a ripple effect throughout the economy that impacts the entire nation. We can look to subprime mortgage lending as an indicator of how subprime automobile finance may affect the economy. Even as recently as one and a half years ago, it was generally thought that the subprime market was fairly

financial system. In fact, Federal Reserve Chairman Ben

troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest

51

Today, we know that this is not the case. The state of the subprime housing market crisis and its negative effect on

The government takeovers of Fannie Mae and Freddie Mac, and the partial nationalization of nine major banks,[52] also indicate the significant impact that the subprime mortgage market has on everyday life. The subprime automobile finance market, if left unchecked, may have a similar negative

Investors Service data shows that as of March 2008, the

covered by this act include banks, mortgage lenders, credit card companies, automobile financing companies, and any other consumer loan originator to whom the debt is payable. They are required to disclose the finance charges and annual percentage rate of the loan to the applicant. The Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision, the Bureau of Federal Credit Unions, the Farm Credit Administration, and the Federal Trade Commission are all responsible for enforcing the Truth in Lending Act with lenders under their purview. Punishment for non-compliance is limited to fines not more than $5,000 or one year imprisonment.[54]

While the Truth in Lending Act is a vital disclosure requirement for individual consumers, it requires transparency only in the case of specific transactions or credit offers. The Act does nothing to reveal systematic discrimination or usurious lending policies by lending companies or the greater automobile finance industry. It also does not require disclosure of important automobile lending factors, including add-ons, the amount of dealer markup on the interest rate, unnecessary insurance uirements, Many automobile dealers also use high-pressure sales tactics to keep customers in the dealership until a purchase contract is signed a practice which acts as a barrier to rate comparison between multiple dealers or finance companies.

Because transportation is such an important and immediate need for workers and families, disclosures under the Truth in Lending Act may have little impact on automobile purchases. In the home mortgage industry, the contract and purchasing process can take months to complete, giving sellers and buyers ample time to reconsider the transaction. Vehicle purchases can take place in a matter of hours, if not minutes, leaving little opportunity for a thoughtful, rational decision.

The Community Reinvestment Act[55] is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, and is enforced by the federal agencies responsible for supervising depository institutions. This act covers all financial transactions involving credit, including home mortgages, small business loans, small farm loans, community development loans, and consumer credit loans (including motor vehicle loans). For consumer loans, the Act requires collection of the loan amount, the loan location (by census tract), and the gross annual income of the applicant from institutions where consumer lending is the majority of its portfolio (this is a rare situation, so consumer lending provisions under CRA are not significant).[56] If lenders do not request or consider income when making a loan, they are not required to report it. Data is collected by the governing agencies, aggregated, and made available to the public.

The Community Reinvestment Act is designed only to indicate whether banks are lending to communities in which they are located and take deposits. It does not govern non-depository institutions like indirect lenders in [57] (e.g. General Motors Finance Corporation) or Buy Here Pay Here dealers, both of which contribute significantly to the total number of automobile industry loans. Captives and other non-depository automobile lenders are best positioned to dominate originations they have access to the customer at the point of sale, and they often use financing as a form of discounting in order to drive sales. Captives and independent finance companies account for about three-quarters of all new automobile loan originations, but are not regulated by the Community Reinvestment Act.[58]

Another potential source of regulation concerning disclosure is the Fair and Accurate Credit Transactions (FACT) Act. There is a proposed amendment to this Act (which is, in itself, an amendment to the Fair Credit Reporting Act) to require lenders to provide notice to

interest rate on a loan than most other consumers because of a detrimental item in their credit history.[59] The amendment states that consumers who receive the higher interest rate will receive a notice of the rate and a free copy of their credit report.[60] It is unclear how useful this amendment will be for automobile loan customers. There are many exceptions to the reporting requirements[61] that could be manipulated by automobile lenders to best serve their interests and not those of the consumer. There is already question from some members of the banking

-to-consumer

ich

customers need disclosures.[62] This could prove to be an expensive and burdensome task for the industry. On the other hand, data disclosure involving reporting of information from the loan application (like in HMDA) is

the industry.

The lopsided access to information in the automobile market, due largely to a lack of disclosure, has a disparate impact on low-wage workers and their communities. A national sample of 650,000 car purchases revealed that low-wage consumers typically paid between $50 and $500 more for the same car, and an extra two percentage points on the resulting loan, than consumers from high-income neighborhoods.[63] Communities of predominantly low-wage workers also pay higher interest rates on average.[64] While these statistics are descriptive and provide an overview of the situation, analysis of low-wage car purchasers could be even more meaningful and provide more statistical proof of payment differentials if information such as credit ratings were available to researchers. Data reporting requirements for automobile loans can help further qualify studies like this. It is important to remember, however, that low income alone does not always translate to a higher credit risk and does not justify higher interest rates.

previously underserved groups, such as moderate-income families and minorities.[76] In 2004, the nationwide home ownership rate was 70%, up from 64% in 1994.[77] This increase is largely attributable to mortgages being made available to consumers who may have been denied credit prior to updated HMDA regulations.[78] Until 1998, subprime lending was not common few borrowers received subprime loans. Shortly thereafter, lenders discovered the profitability of subprime loans, and the industry skyrocketed.[79] While unethical forms of subprime lending

is general agreement among economists that HMDA has helped stimulate lending in low to moderate income households and, in turn, improve the credit services available within low to moderate income communities.[80] HMDA data can help lenders improve the products and services that they offer to all customers, and can help them expand their markets.[81]

The FDIC and several other federal regulatory agencies use

fair lending laws. The data allow the agencies to assess any discriminatory lending practices and take corrective action. Between 2004 and 2007, the FDIC referred 115 cases of illegal lending discrimination to the Department of Justice for review.[82] In 103 of the cases, the offending banks were required to remedy the harm that they had done to the consumers, advise them of their right to sue, and cease all additional discriminatory action.[83]

V. RECOMMENDATIONS: THE CALL FOR ACTION

Based on the current lack of oversight in the automobile finance industry and the positive outcomes in the mortgage market as a result of HMDA regulation, more transparency, accountability, and oversight are clearly necessary. If lenders are required to report statistics on vehicle loans that parallel those reported for home mortgages, the public will have access to valuable data that will help protect consumers and identify discriminatory or usurious lending patterns. Violators of fair lending laws should suffer appropriate penalties and be ordered to cease their unlawful practices. Our recommendations include:

1) **Start a conversation among advocates, policymakers, researchers, and others about specific next steps for improving the data collection and accountability for the automobile finance industry and shaping specific policy changes that can be furthered at both the federal and state levels.**

2) **Educate legislators about the need to implement a data disclosure act, similar to HMDA, for the automobile industry.**

HMDA experts generally agree that regulation similar to HMDA for the automobile finance industry would benefit consumers.[84] Transparency and disclosure are critical components of reigning in unethical lenders so that *all* vehicle loan applicants can have fair access to reasonable credit terms. Obtaining a vehicle at a fair cost is especially important to low-wage families who must have affordable, reliable transportation to commute to work. If these citizens can develop a solid credit history, maintain employment, and build their assets, they will become the foundation for stronger communities.

3) Support disclosure legislation that contains automobile industry-specific reporting requirements, in addition to those required by HMDA

Disclosure legislation for the automobile finance industry should contain data requirements mirroring those in HMDA, such as race, ethnicity, gender and income, as well as data specific to the automobile finance industry. This data would include total interest rate, dealer markup

credit score. Some HMDA experts also believe that the age of the borrower is important to disclose.[85] While advocates have not been successful in adding age or credit score to HMDA requirements to date, these are important factors in the request for automobile industry reporting. Privacy concerns have been cited as a reason for excluding credit scores from HMDA data. Including credit scores of automobile buyers in publicly accessible data does not pose as much of a privacy risk since it is difficult to trace an automobile purchase to a specific address (and buyer). Credit score data can also be aggregated for reporting so that individual [86]

Banks already have the technology in place for HMDA reporting, so the data should be easy to report for automobile loans made by those institutions who already report HMDA data. There are automobile financiers who do not offer mortgage loans, so new reporting systems would have to be implemented at these businesses. However, they do capture loan application data in some type of electronic format, so there should be a simple way to capture and transmit this data for required reporting purposes.[87]

4) Introduce the reporting requirements in stages, beginning with requirements that apply to automobile dealers who provide financing to customers

Because the majority of automobile purchasers finance their vehicle through the dealer, they should be the primary focus of reporting requirements. By 2011, dealers should have all systems in place to report the required data on any loans they make. Data could be aggregated at the regional level through a regional manager and forwarded to the appropriate collection agency.

5) Assign clear oversight and regulatory responsibilities to a federal agency

The Department of Justice (DOJ) is the best agency to oversee compliance with data disclosure requirements among lenders. DOJ, in conjunction with the Federal Trade Commission, already has a role in the oversight of automobile transactions, so it is logical that they would oversee reporting requirements related to financing involved in the sale of a vehicle. We suggest a federal agency for two reasons; first, HMDA compliance oversight resides with several federal agencies (including DOJ), and second, since this is a national proposal, it is important to have national jurisdiction. Some states have regulations in place to protect automobile purchasers who finance their vehicles, but the breadth of regulation and the level of enforcement are not consistent among states.

6) Remove legislative barriers that inhibit the collection of pertinent borrower data, such as race, ethnicity, or other personal characteristics (i.e. Regulation B of the Equal Credit Opportunity Act)[88]

In order for our proposed data reporting requirements to be enacted into law, we need legislators to reverse the stipulations of Regulation B. It was originally put in place to provide a non-discriminatory credit approval process to applicants, but many opponents argue that the lack of available personal data can lead to discrimination, and at the very least, makes it difficult to identify discrimination (as it was in the home mortgage industry prior to HMDA).[89] The House Financial Services Committee has heard testimony urging them to overturn Regulation B and require every financial institution with assets greater than one billion dollars to disclose race, gender, and ethnicity for all small business loans made by 2011. Congressman

optimistic that the proposal will be introduced and passed in 2009.[90] The same case for overturning Regulation B would come from automobile loan disclosure as well.

As our nation struggles with the aftermath of the subprime mortgage fiasco, we need to be proactive in preventing a similar situation within the subprime automobile finance market. Implementing disclosure regulations for the automobile finance industry, similar to HMDA, is crucial for the benefit of our communities and the strength of our economy.

Endnotes

1

http://www.boston.com/news/local/massachusetts/articles/2008/03/07/entering_the_repossession_lane/

2 ibid.

3 ibid.

4 ibid.

5 ibid.

6 ibid.

7 The Associated Pres

8 ibid.

9 -

lenders; weekly or bi-weekly payments are made directly to the dealer.

10 Office of Thrift Supervision. Examination Handbook. Section 1215. August 2006.

11 Thompson, Sandra L. Rooting out Discrimination in Mortgage Lending. Statement to the Oversight and Investments Subcommittee of the Financial Services Committee, U.S. House of Representatives, July 25, 2007.

12 Fishbein, Allen. Personal Interview. September 8, 2008.

13

14

Brookings Institution Policy Brief, Center on Children and Families, no. 35, December 2005.

15 Van Alst, John. Fueling Fair Practices. Page 2. NOT YET PUBLISHED.

16 Blumenberg,

2003.

17 Blumenberg, Evelyn and Michael Manvil

-205.

18

Transportation Reform Series for the Metropolitan Policy Program at Brookings, The Brookings Institution, February 2008.

19 The subprime market varies in definition. For this paper we are using the common threshold of a FICO score of 640 or lower to define the subprime market.

20 http://www.investopedia.com.

21 Sutton, Remar. Car Financing for Low and Moderate Income Consumers. June 2006.

22

23 ibid.

Fried reports that in 2006 automotive sales totaled nearly $790 billion, of which $527 billion were financed.

24 ibid.

25 ibid.

26 Kim, Anne, Taken for a Ride. Progressive Policy Institute, November 2002.

28 ibid.

29 $10,000 and financed for 60 months at 8% interest would result in a monthly payment of $202.76. The same loan at an 18% interest rate would have a payment of $253.93. Over the life of the loan, a subprime borrower will pay $3070.20 more than the prime borrower.

30 Philips, Chandler. Confessions of a Car Salesman. http://www.edmunds.com. Also Reed, Phillips and Nick James. Confessions of an Auto Finance Manager. http://www.edmunds.com.

subconscious willingness to agree to

though customers have no choice but to accept one package or another), to downright lying: finance managers admit to telling customers that an extended warranty is required to qualify for financing.

31 Hernandez-Darrow, Shannon. Auto Finance Add-Ons: Little Bang for the Buck. Southwest Regional Office of Consumers Union, March 2003.

32

33 ibid.

34 ibid.

35 Bradford, Calvin. Personal Interview. September 16, 2008.

36 Van Alst, John. Personal Interview. October 29, 2008.

37 ibid.

38 u About. American Chronicle, April 2007. http://www.americanchronicle.com/articles/23408

39 ibid.

40 Fried, Allen, 2007.

41 Kim, Anne, 2002.

42 United for a Fair Economy. State of the Dream 2008: Foreclosed. January 2008.

This report has detailed analysis of subprime mortgages by race. It shows that African-Americans and Hispanics have the highest concentration of high cost home loans and stand to lose the most money from foreclosures because of predatory lenders targeting these groups.

43 Hudson, Michael, 2004.

44 Murguia, Janet. Eroding a Generation of Wealth: Abusive Lending Practices Targeting Latino Communities. Statement to the Subcommittee on Financial Services and General Government, U.S. House of Representatives Appropriation Committee, February 27, 2008.

This article cites a study done by economist Mark Cohen, who analyzed 1.5 million car loan purchase documents across all states and credit tiers. The study concluded that minorities experienced a disparate impact of higher interest rates.

45 Kim, Anne, 2002.

46 ibid.

47 ibid.

48 ibid.

49 Washington State Task Force for Homeowner Security. Final Report. December 2007.

50 ibid.

51 Fried, Allen, 2007.

52

The Washington Post. October 14, 2008.

53 http://www.researchrecap.com/index.php/page/2/?tag=asset-backed-securities.

54 FDIC Law, Regulation, Related Acts. FDIC. http://www.fdic.gov/regulations/laws/rules/6500-200.html

55 A Guide to CRA Data Collection and Reporting. Federal Financial Institutions Examinations Council, January 2001.

56 Silver, Josh, 2008.

57

product.

Miecznikowski, Jan, Evan Hirsh, and Robert Reppa. Rebundling of the Auto Finance Industry. Booz Allen Hamilton, 2004.

58 ibid.

Captives and independent finance companies account for $780 billion out of a total $1.04 trillion in new auto loans.

59 FACTA, The Fair and Accurate Credit Transactions Act: Consumers Win Some, Lose Some. Privacy Rights Clearinghouse. http://www.privacyrights.org/fs/fs6a-facta.htm#11.

60 ibid.

61 -

62 Donald, Jr., Dan L. FACT Act Risk-Based Pricing Rule. May 8, 2008.

http://www.federalreserve.gov/SECRS/2008/August/20080814/R-1316/R-1316_22_1.pdf

63 From Poverty, Opportunity: Putting the Market to Work for Lower Income Families. The Brookings Institution, July 2006.

64 ibid.

65 Fishbein, Allen, 2008.

66 ibid.

67 Austin was a neighborhood in Chicago

68 Immergluck, Dan. Personal Interview. September 26, 2008. Bradford, Calvin, 2008.

69 Immergluck, Dan, 2008.

70 ibid.

71 http://www.ffiec.gov/hmda/history2.htm

72 ibid.

73 Immergluck, Dan, 2008.

74 Silver, Josh, Personal Interview. October 29, 2008.

75 Dugan, John C. Community Developments Online, 2005.

http://www.occ.treas.gov/Cdd/newsletters/summer05/cd/usingthenewhmda.htm.

76 Silver, Josh, 2008.

77 Dugan, John C., 2005.

78 ibid.

79 Silver, Josh, 2008.

80 Dugan, John C., 2005.

81 ibid.

82 Thompson, Sandra L. 2007.

83 ibid.

84 Bradford, Calvin, 2008. Carr, Jim. Personal Interview. September 18, 2008. Fishbein, Allen, 2008. Immergluck, Dan, 2008. McCoy, Patricia. Personal Interview. September 26, 2008. Silver, Josh. Personal Interview. September 18, 2008.

85 ibid.

86 ibid.

87 ibid.

88 Van Alst, John. Regulation B prohibits the collection of protected personal characteristics, such as race and ethnicity, from non-mortgage lenders.

89 Fair Lending: Race and Gender Data are Limited for Non-Mortgage Lending. http://www.allbusiness.com/banking-finance/banking-lending-credit-services/11509109-1.html. August 1, 2008.

90 Financial Institutions May Soon be Required to Report Business Loans by Race, Ethnicity, and Gender. http://www.greenlining.org/resources/pdfs/regbglifactsheet.