

SUPPORT THE BROWNBAC/CAMPBELL DEALER LANGUAGE
Preserve Affordable Auto Finance Options for Consumers in the
Wall Street Reform Bill (H.R. 4173)

Questions and Answers

1. If the Brownback/Campbell language were adopted, what would regulation of auto loans look like from the bank/finance company perspective?

The Brownback/Campbell language would have no impact on the ability of the Bureau of Consumer Financial Protection (CFPB) to regulate the companies that underwrite, fund, and service auto loans. These companies (finance sources) include captive and independent finance companies, banks, credit unions, and automobile dealers whose business model includes self funding their retail installment sales contracts and lease agreements.

Since auto loans would be regulated by the CFPB, finance sources would, as they do presently, require by contract that dealers take the actions necessary to facilitate their compliance with any new credit regulations.

2. If the Brownback/Campbell language were adopted, what would regulation of auto loans look like from the dealer's perspective?

Dealers' retail financing activity would continue to be regulated by the Federal Reserve Board and the Federal Trade Commission and dealers would continue to be subject to the full range of federal laws and regulations that currently apply to their operations (e.g., Truth In Lending Act, Federal Consumer Leasing Act, Equal Credit Opportunity Act, Fair Credit Reporting Act, Gramm-Leach-Bliley Act, Federal Trade Commission Act, etc.). In addition, unlike many banks today, dealers would continue to be subject to the myriad of state laws and regulations that govern their operations as well as to their state consumer fraud statutes.

Dealers also would have to conform to (i) changes to current federal regulations governing their operations that are initiated by the CFPB and adopted by the Federal Reserve Board and Federal Trade Commission, and (ii) additional contractual requirements imposed by finance sources subject to CFPB regulation, as outlined in response #1.

3. If the Brownback/Campbell language were adopted, what would regulation of auto loans look like from the customer's perspective?

Consumers would not experience any type of gap in the regulation of auto loans. Every auto loan has a finance source and finance sources would be subject to CFPB regulation. Consequently, auto loans would not go unregulated.

4. Assistant Secretary of Treasury Michael Barr stated that "Excessive credit card borrowing and auto lending fed an irresponsible wave of cash-out refinancing and

home equity loans that have now left millions underwater." Has excessive auto lending left millions "underwater"?

The Assistant Secretary's statement does not focus on either the fundamental distinction between auto and home mortgage lending or the reason why auto lending did not create the financial meltdown – namely, that auto lending involves rapidly depreciating collateral that requires finance sources to develop strict underwriting criteria that focus on the borrower's ability to repay the financing obligation. Contrarily, subprime mortgage lending largely ignored the borrower's repayment ability and instead relied on the appreciation of the loan collateral. It thus is unsurprising that auto lending typically is not mentioned as a cause of the financial crisis.

The Assistant Secretary's statement is not, however, germane to the Brownback/Campbell language as the language would leave finance sources that must approve auto lending decisions fully subject to CFPB regulation.

5. Are there laws or practices in place that deter dealers from steering consumers to higher rate loans?

Dealers have no financial incentive to steer consumers to higher loan rates. In fact, they have a disincentive to do so. Consider the following:

Dealers typically forward the consumer's credit application to multiple finance sources with which the dealer has a contractual relationship. The finance sources conduct underwriting on the consumer's credit application and, if approved, provide the dealer with a wholesale rate at which the finance source will buy the retail installment sales contract from the dealer (known as the "buy rate"). Finance sources today routinely limit or cap the retail margin that dealers may earn for providing the retail infrastructure for delivering this product (typically 2-2.5% depending on the duration of the contract).

Suppose: (i) two finance sources approve a consumer's credit application, with Finance Source A providing a wholesale buy rate of 4% and Finance Source B providing a wholesale buy rate of 4.5%; (ii) **each finance source caps the dealer's retail margin for delivering the financing at 2%**; (iii) the consumer is able to arrange financing from a source other than through the dealer at a retail rate of 6.25%; and (iv) in order to earn the consumer's financing business, the dealer offers the consumer a retail rate of 6%. In this example, the dealer would earn the full 2% if it arranges financing with Finance Source A, while only earning 1.5% if it arranges financing with Finance Source B. Not only does the dealer clearly have an economic incentive to seek the lowest -- not the highest -- buy rate, the foregoing example demonstrates that the consumer benefits when there is competition between lenders.

Of course, focusing on a creditor's cost of funds, whether from a dealer, bank, credit union, etc., is a red herring because it is not a rate at which funds can economically be lent to consumers and, therefore, is not generally available to them. This is why consumer disclosure requirements typically focus exclusively on the retail rate (also known as the APR) as it is the only meaningful and relevant figure for comparing rates. See, 42 Fed. Reg. 19,125 (Apr. 12, 1977), where the Federal Reserve Board stated: "... The dealer's participation in the finance

charge may serve as compensation for the work done in arranging the financing and for the risk of loss which is shared with the lending institution. Therefore, the Board believes that, in many instances, the portion of the finance charge which represents the dealer's participation is not an amount which the consumer could save by obtaining a direct loan from a lending institution."¹

6. What is the difference between what a mortgage broker does and franchised auto dealer-assisted financing?

There are significant differences between mortgage brokers and franchised dealers. First, as House Financial Services Committee Chairman Barney Frank (D-MA) pointed out during the markup of the CFPB bill, dealers possess inventories, and mortgage brokers do not. The dealer's vehicle inventory requires dealers to commit actual funds during the transaction. Mortgage brokers do not carry inventories. The way this works is as follows: (i) a dealer purchases vehicles from the vehicle manufacturer using a prearranged inventory line of credit known as a "floorplan" loan; (ii) the dealer pays off the floorplan loan by making monthly interest payments to the floorplan finance source and, upon the sale of each vehicle, paying to the floorplan finance source the cost at which it purchased the specific vehicle from the manufacturer; and (iii) the dealer then receives payment for the vehicle from the finance source to which it assigns the consumer's vehicle finance contract.

Typically, the dealer must pay off the floorplan finance source within 3 days of the date of the vehicle sale, while it usually takes longer to receive payment for the vehicle from the finance source to which the dealer assigns the finance contract. Thus, when dealers arrange financing for consumers, they are engaged in a transaction that is very different from the "table funding" that exists in the mortgage broker industry.

Second, dealers sell products besides the financing for the new car. Dealers have a strong business incentive to provide consumers with reasonable and competitive financing terms, as consumers who feel "cheated" are unlikely to return to the dealership to have their vehicle serviced or for future purchases. This long term customer retention effort, known as the "Customer for Life" concept, is not typical in the mortgage broker industry.

Next, dealers may lose all or a portion of the amount they earn on the finance contract (typically referred to as "dealer participation" or "dealer reserve") if they extend financing that a consumer cannot afford and the consumer subsequently defaults on its payment obligation.

Finally, dealers that extend financing at above market rates risk consumers refinancing their loan. When this happens, the dealer could lose money on the transaction and the trust of the consumer. Unlike refinancing a home, consumers can refinance a vehicle quickly and for only a nominal fee, and dealers and lenders are well aware of this fact, which disciplines the entire indirect lending market.

¹ See also [Geller v. Onyx Acceptance Corp.](#), 2001 WL 1711313 (Cal.Superior Nov 13, 2001) and the 2004 FTC Bureau of Economics Report entitled *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment* at www.ftc.gov/opa/2004/02/mortgagerpt.shtm.

7. Do dealers receive "hidden bonuses" for facilitating auto loans for their customers?

No. Dealers, as with all other retailers in America, obtain products at a wholesale rate and include a retail margin in the price they charge to consumers. The same is true with community banks and credit unions. Neither lend to consumers at their cost of funds. Therefore, it is inaccurate to characterize the difference between their cost of funds and their retail rate as a "hidden bonus."

8. Isn't the Senate Financial Regulation bill merely a consolidation of existing authorities?

No. The Senate Bill would transfer regulatory responsibility over the enumerated statutes (i) to a new agency (the CFPB) that would regulate industries that significantly contributed to the credit crisis (e.g., Wall Street financial firms) along with those that had nothing to do with it (e.g., Main Street auto dealerships), and (ii) away from the agencies (Federal Reserve Board and FTC) that, in the context of auto lending, developed over a generation a carefully constructed regulatory regime that effectively balances the interests of consumers and businesses. It also grants the CFPB with new authorities (e.g., the authority to create new disclosure obligations on businesses, and prohibit certain activities related to selling and advertising consumer financial products and services) and, most significantly, empowers the CFPB to declare business practices as unfair, deceptive, and abusive without the protections afforded by the federal Magnuson-Moss Warranty Act. This represents a significant departure from the set of regulations currently governing optional dealer-arranged auto financing.

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