Car Financing for Low and Moderate Income Consumers

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Car Financing For Low And Moderate Income Consumers

By Remar Sutton[1]

Assignment

My team was asked to define the universe of readily available vehicle financing options for low and moderate income (LMI) consumers, focusing on the for-profit sector but including not-for-profit options such as Ways to Work and Working Wheels. We have also addressed several other closely related questions and issues.

Summary

For the purposes of this paper we are defining the LMI universe as consumers with a credit rating of D and below (typically characterized as sub-prime) and generally those with an income below $40,000. Credit scores appear to be a valid marker for defining 'LMI' consumers.[2]

Each year, over 100 billion dollars in car loans are made to LMI consumers. Assuming an average loan of $12,000,[3] over eight million low and moderate-income consumers receive auto loans. Eight million is a very conservative number. The number of consumers in all likelihood is at least twice as high, over sixteen million, and this larger number encompasses those with the greatest need. For instance, the eight million figure includes only those consumers with a valid social security number and a credit score. In one sample, about 40% of consumers who approached Working Wheels did not have

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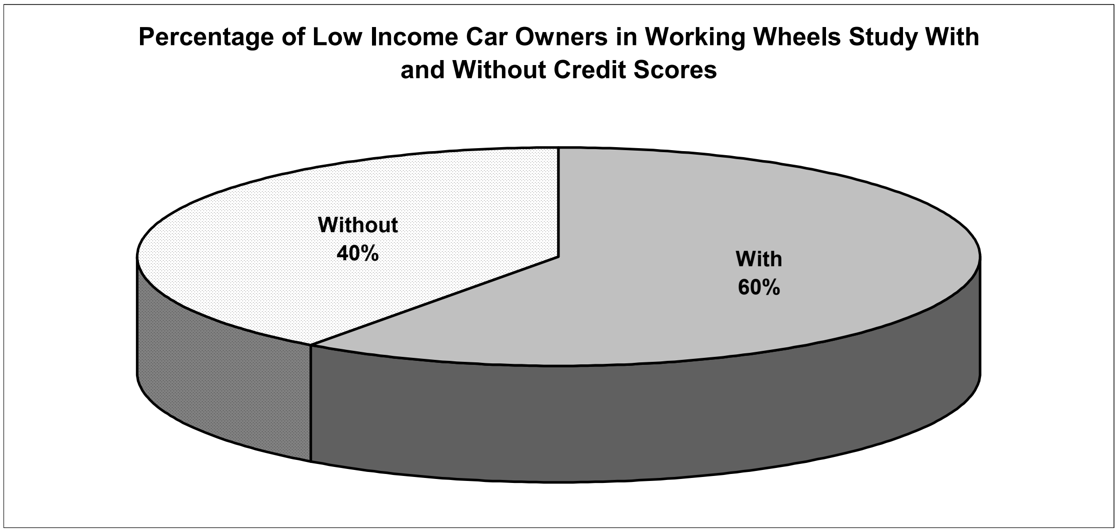
[1] I am co-founder and president of the non-profit Consumer Task Force For Automotive Issues, and the author of a book on the car selling process, *Don't Get Taken Every Time*. I am also a pro-bono consultant to state attorneys general and others interested in the automotive arena.

[2] Not all lenders may assign a letter category such as A-E to consumer credit scores, and some may have a category that goes from A+ to D, for example. But all lenders use the credit scores. We are using an A-H scale in this study, a common scale at many lenders.

[3] For many of the numbers in this report that deal with the statistics of LMI borrowing patterns, we are using the actual data developed in a 22-month sub-prime lending program conducted at University Federal Credit Union in Austin, Texas. UFCU is a large credit union. During the 22-month test program at UFCU, the credit union received over 30,000 car loan applications from consumers. Approximately 7,000 of these applications were from sub-prime applicants. The program universe was therefore a substantial test universe, and has proved very valuable as perhaps the largest such test program available. We found the data invaluable, and we found that it confirmed many assumptions concerning LMI borrowers. For instance, we are using the average loan size from this study to confirm our projected number of borrowers. We are also using actual numbers from this program to establish our income ceiling for LMI consumers at around $40,000. In a study of 2,000 D/E loans we dropped those with incomes over $50,000 per year. The majority of those with incomes over $50,000 had dramatically higher incomes, which indicate affluent consumers who simply don't pay their bills. When we average the income after dropping out these 49 (out of 2,000) consumers, the average income was under $40,000 per year. Even including the 49 high-income loans, the average income in the Austin loans was under $48,000 per year. About 20% of the consumers had an income under $24,000 per year.

credit scores.[4] (Their average income was $14,000 per year. (See Figure 1.) The eight million figure also does not include "Buy Here/Pay Here" consumers, which probably numbers in the millions and perhaps represent a minimum $5 billion market annually.

Figure 1. Percentage of Low Income Car Owners in Working Wheels Study With and Without Credit Scores.



Additionally, the eight million number does not include consumers with incomes over $40,000. In many definitions, 'low and moderate income' could include families in many parts of the country with incomes over $50,000 per year.

Whatever the number, these consumers generally reside in the sub-prime credit categories, and probably 95% at best have no access (or don't know they have access) to credit other than by using unnecessarily expensive sub-prime lending sources, or worse, by using Buy Here/Pay Here schemes. BHPH is one of the fastest growing areas of sub-prime lending and now involves new car dealer franchises at times in partnership with all types of lending pools.

The players in the sub-prime auto-lending field

An important note: The categories of players in the for-profit sub-prime auto-lending field are ill defined and, at times, overlapping. The categories also don't tell the true story. Probably over ninety percent of sub-prime loan decisions are made by the "loan

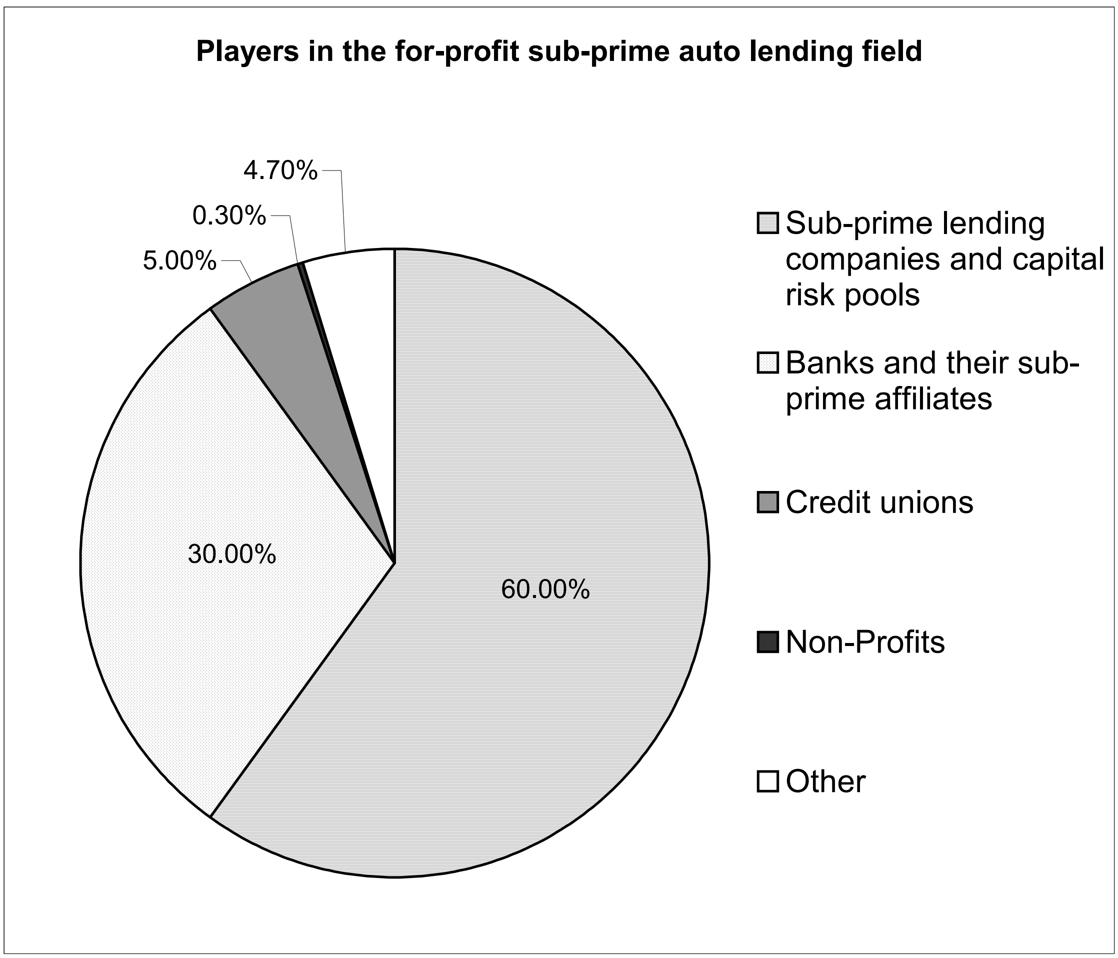
[4] Gaining Traction, Working Draft, page 13, under 'Credit" paragraph. In the UFCU test program, where the universe of borrowers included a generally affluent membership base, the percentage of those without credit reports was much smaller, probably around ten percent. But the percentage without credit reports escalates dramatically as income falls.

facilitator," the finance officer or software program that actually applies for the loan and decides both with what company the consumer will finance and what rate the consumer will pay for the loan. The facilitator may use a bank or the worst sub-prime lending company. The consumer generally has no say in this decision (although they could, and should). The facilitator generally chooses the loan source that pays the biggest profit to the facilitator, not the loan source that may be cheaper or better suited for the consumer.

The Players

- Sub-prime lending companies and capital risk pools (over 60% of funding for sub-prime auto loans)
- Banks and their sub-prime affiliates (under 30%)
- Credit unions (under 5%)
- Non-Profits and community-based groups (probably less than ⅓ of 1%)

Figure 2. Players in the $100 billion-plus for-profit sub-prime auto lending field.



Other key summary points

- A credit score (or the lack of a credit score) is much more important than income in determining if a consumer falls into the sub-prime lending category.
- Many low-income consumers do not have credit scores and therefore are effectively locked out of the larger sub-prime credit market.
- Conversely, the *opportunity* for a consumer to receive the most favorable loan terms is generally tied to credit-worthiness, not income.
- The car market for LMI consumers is (and should be) virtually all used cars, not new cars. Sellers prefer used cars because their return on investment on a used car can be dramatically higher than on a new one. The seller can make a dramatically larger profit on both the sale of the vehicle and the sale of financing. Consumers can also receive much more value for the money—if the vehicle and financing are wisely arranged. But that is a very big "if."
- Most vehicle sellers and loan facilitators in the sub-prime lending arena try to increase their profit on both the car and the loan more than their potential increased risk would require.
- New car auto dealers are entering the Buy Here-Pay Here (BHPH) market, a dramatic development that has far-reaching (and probably very negative) implications for LMI consumers. Many new car dealers look upon BHPH operations as a way to sell poor quality vehicles that would normally be wholesaled at no profit to LMI consumers at a large profit. More on this later.
- There may be a complex but readily available solution to the abuse many LMI consumers face when it comes to buying and financing a vehicle.

Background

Each year on average over 40 million vehicles are sold to end-users in the United States. About 15 million of those vehicles are new (untitled) vehicles and virtually all of these new vehicles are financed.

At least 25 million used vehicles are sold each year. About 12 million are sold at franchise new- and used-car dealerships alone. The total number of used sales is probably considerably higher, at least 30 million. But accurate records for the sale of much older, less expensive vehicles are either not available on a national basis or will not be shared by the record holders. As a vehicle moves down the food chain from new to salvage, the history of that vehicle becomes obscured as its useful value becomes diminished.[5] (Significantly, the *economic value* to a seller of these cars as they age normally *increases*.

[5] Published figures. Numbers vary, and some totals don't include private sales; others don't include vehicles under a certain price range; many vehicles are also sold without proper registration, and aren't included in any available statistics.

In one month, a seller can easily make a 400% return on a thousand dollar, fifteen-year-old, junk vehicle, while the seller of a one-year-old vehicle would be happy with a 10% return in a year. This phenomenon, along with the interest rate dynamics of financing older vehicles, drives the new-car auto businesses' rapidly increasing interest in the sub-prime car market.)

We look at the used market. For the purposes of our assignment, we are looking at used-vehicles only. Used vehicles have historically been almost the sole vehicle universe for the vast majority of LMI consumers. (About two-thirds of all car sales are sales of used vehicles, and lower income consumers purchase the vast majority of used vehicles. Over 80 percent of all used vehicles sold at retail are "financed," paid for over time. Probably an even higher percentage of used vehicles sold to LMI consumers are financed. The accurate records of that financing, as with the accurate records of the vehicle's history, disappear into the ether as the creditworthiness of a consumer (as defined by the three major credit reporting agencies and their credit scoring mechanisms) diminishes.

For instance, most Buy Here, Pay Here financing operations, which deal with people who think they have no other finance options (although many do), commonly don't report either their sales or the payment history on those sales to outside sources or to credit bureaus.[6]The vast majority of BHPH consumers are low and middle-income consumers.[7]

As a consumer moves down the financing food chain towards the BHPH vehicle sources, the very definition of "financing" begins to change. It morphs from a common definition of interest—the cost of a vehicle over time compared to its cost if paid for in cash —to a much broader definition of financing cost to the purchaser. This definition encompasses not only any "interest," but also encompasses a higher price for the vehicle itself simply because the customer is rated a higher risk or a BHPH customer. This higher vehicle price is masked in the negotiation and financing, escaping the implications of any usury issues. It also obscures the issue of the true cost of vehicle financing.[8]

What qualifies a person for the best loan? Whatever the cost of financing, the *opportunity* for the best possible loan is generally tied to creditworthiness. But as the total cost of financing is hard to pinpoint, so is the very definition of creditworthiness. By and large, income and creditworthiness do not have to go hand-in-hand. Many consumers defined as "sub-prime" credit risks by traditional lenders have high incomes, fine homes, and more than one new car. Conversely, many young people with low incomes but stable jobs and responsible buying habits are rated very creditworthy.

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[6] In fact, "The mere existence of buy here-pay here accounts and rent-to-own accounts on a person's credit report can lower their credit rating," says Ira Rheingold, executive director of the National Association of Consumer Advocates. But these payments, along with payments for such things as utility bills, could probably help establish some form of credit history. Some non-mainstream databases based on items like these are becoming available now, but seldom is this information accepted by the three major credit bureaus.

[7] There is no national policy or requirement for BHPH dealers to report payment history. The major BHPH trade association would not provide us an answer to this question. Individual BHPH operations may report delinquencies. But the general consensus indicates BHPH dealers do not regularly report payment history.

[8] I have written for many years about the 'opportunity pricing' employed by many sub-prime sellers.

Before dealing with the players in vehicle finance, we should therefore first look at how virtually all providers of financing (with the exception of certain not-for-profits and individual loan placements) determine the creditworthiness of all potential customers. For the only time in this paper, the answer is relatively clear-cut: creditworthiness is determined almost always on an individual's credit score. These scores are for the most part developed by three major for-profit credit scoring companies. The companies at times develop separate scoring models for different loan products, such as vehicle loans.

Many major lenders also develop their own credit scoring mechanisms. For instance, a typical large bank or credit union may have over 100 different credit-scoring models from to choose. But normally speaking, the credit scores developed by the three major reporting bureaus (called a "FICO" score because they are based on the model originally developed by the Fair Isaac Company) are considered by many lenders as the best indicators of creditworthiness.

To develop a FICO score, a credit reporting bureau must have a least one account that has been opened for at least six months, and must have at least one account that has been updated in the past six months. Many very low-income first-time borrowers in the car market, as we mentioned, do not have credit scores. While there are no reliable national statistics on the number of people who do not have a FICO score, the data developed using the Working Wheels car owner records and similar data from limited other sources does show that perhaps 40% of low income (and an undetermined percentage of moderate income) owners do not have credit scores.[9]

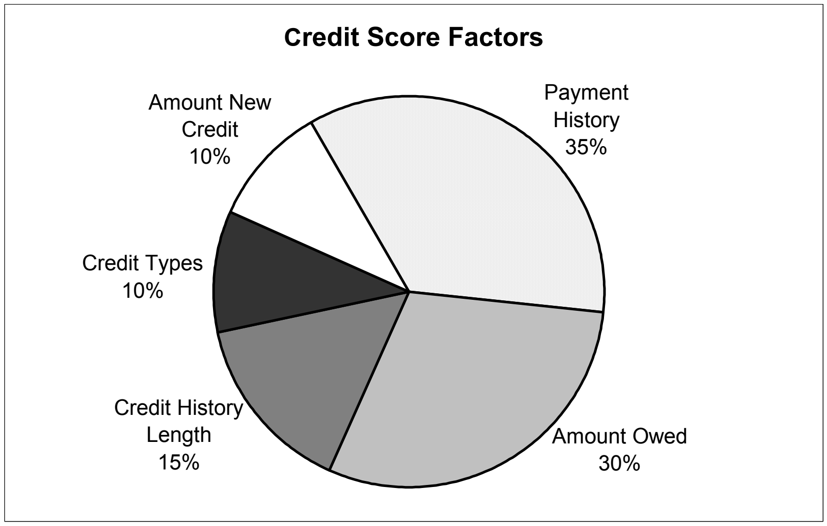
What's the score? Whatever the number, credit scores or the lack of them—and "risk-based" financing, based on these scores—will drive the rest of this story. Risk-based financing procedures assign an interest rate related to risk, and have the potential of being the LMI consumers' best friend. Before the use of risk-based financing, LMI consumers with impaired or little credit were simply rejected for auto loans at standard financing institutions. LMI customers with impaired credit were (and still are, for the most part) rejected outright by the national credit union movement. Out the door! LMI borrowers had few options for financing other than with the worst possible lending sources.

We will deal with risk-based financing later in this report because it may offer a road map to safer ground for LMI borrowers. But that map starts with the credit score.

[9] The 40 percent number may be accurate for those in the very low-income brackets, and is in all likelihood high for those in moderate-income brackets. As mentioned, the UFCU study showed that ten percent of 30,000 car loan applicants didn't have social security numbers.

How credit scores work. Credit scores rate each individual's creditworthiness on a numerical scale from about 300 to about 850. Numerical numbers are also broken down into alphabetical categories. Each bureau's exact formula for determining that score is guarded closely, but the formulas include such factors at payment history, the amount a person owes, the length of the credit history, the types of credit, and the amount of new credit.[10] Income *per se* is not a stated part of the formulas, although it probably plays a role. For instance, those with less disposable income may make more late payments.

Figure 3. Credit Score Factors.



No nationally agreed upon standard exists for what constitutes the lowest "good" score—"good" being a score which will usually allow you to finance with a "traditional" lending source, as some lenders define the market. But most mainstream lending institutions generally use the 600 score to delineate between prime and sub-prime lending, the difference between "C" risk and "D" risk in this paper.

On average, the percentages of consumers in each numerical category break down like this:

Credit scores generally qualifying for standard loans

- 850-800 13% "A" tier
- 799-750 27% "B+" tier
- 749-700 18% "B" tier
- 699-650 15% "C+" tier
- 649-600 12% "C" tier

[10] These factors normally constitute the FICO general formula: 35% payment history, 30% amount a person owes, 15% the length of the credit history, 10% the types of credit, and 10% the amount of new credit. Liz Pulliam Weston's book, *Your Credit Score,* is a good primer on this topic.

Sub-prime Scores

- *599-550 8% "D" tier*
- *549-500 5% "E" tier*
- *499-300 2% "F-G-H" tier* [11]

A consumer with a credit score above 750 normally would qualify for the lowest rate offered by many financing companies. As the consumers' scores decrease from there, the rates increase, normally at an ever-increasing pace.

"Qualifying" and "Receiving" aren't the same. Keep in mind that simply qualifying for any rate does not guarantee you that rate. Without negotiating skills, even an "A" risk consumer can commonly pay 5-10% more in loan profit on a used vehicle than they need to. In most states the "spread" on used car loans (the difference between the buy and sell rate of money) is normally much higher than the spread on new-car loans, and creates this profit opportunity for the lender. [12]

Some lending institutions as a matter of policy charge the same or close to the same rate for used-car loans as they do for new-car loans. For instance, most credit unions and some banks do this. However, the vast majority of vehicle sellers (as opposed to finance providers) look upon the used-car spread as a valid and even noble profit opportunity and "work" customers to obtain this extra profit on the loan. At most dealerships, large and small, this income and the income from products solely related to the sale of financing (such as service agreements and some insurance products) provide the largest dealer profits.

Whatever the interest rate, the credit score should drive it, in a very pure way. That is, persons with the same score are theoretically eligible to receive the same financing rate, if bargaining skills and other variables like race and geography are removed from the equation.[13]

It is important to note that in a pure sense, the *interest rate itself* should cover the additional risk of lending to consumers with higher risks of default. For instance, if an

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[11] Published by the credit bureaus.

[12] A consumer who allows a facilitator such as a car dealer to determine the loan source can easily pay $2,000 more in interest than they need to pay. This very steady number is confirmed over the past four years by the tens of thousands of credit unions members who first financed their vehicles at car dealerships and then refinanced them at credit unions. The average interest savings was generally over $2,000 per member. This number is the average of consumers who actually refinanced their loans, and doesn't reflect those consumers who would not have saved money by converting their loans.

[13] Factors such as race probably play an additional role in determining what interest rate a person receives. Though all lenders strongly deny the race factor, the recent study by Stuart Rossman and the National Consumer Law Center indicates otherwise, at least when it comes to African Americans. Mr. Rossman analyzed over 200,000 consumers' records, and concluded that "data provide strong empirical evidence of a disparate impact on African-American borrowers."

"A" credit consumer receives a 6% APR loan, and a "D" consumer receives a 14% APR loan, the higher rate could be justified *if the additional money is used to offset the additional risk*. The relative profit to the risk taker would remain the same.

It doesn't work that way in most auto lending scenarios—and it certainly doesn't work that way in sub-prime lending. The risk taker does, indeed, charge a higher 'buy' rate to cover their risk. But in sub-prime lending in particular, *the loan facilitator feels entitled to a higher profit, on both the vehicle and the loan, even though the loan facilitator's risks have already been covered in the higher interest rate.*[14] Profits per unit can explode as the consumer's credit rating drops into the D-H categories. Many consumer experts refer to risk-based pricing, as it is done in the sub-prime arena, as "opportunity-based" pricing.

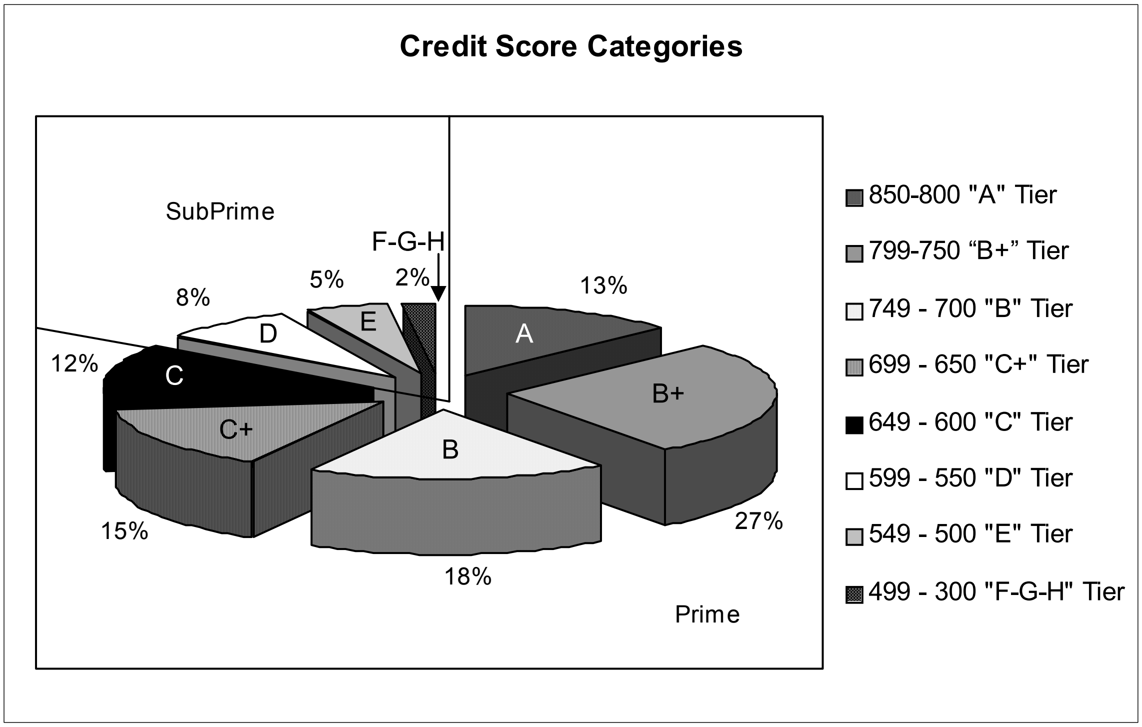
The Target Group for this report. Currently about 15% of people with credit scores fall into the D, E, and FGH credit risk definitions of "sub-prime" (See Figure 4). Probably one of the most accurate ways to define "sub-prime" is a loan that requires special handling: more direct contact by the hands-on lending person, the collection of much more personal tracking data (should the person run from his or her loan), and more "coaching" by the hands-on lending person. The standard mantra used by virtually all sub-prime lenders, including the very responsible ones, is, "We don't care who you pay as long as you pay us."[15]

I consider this 15 percent subset, of consumers rated as sub-prime risks, the principal subjects of this report. Though income isn't a stated factor in credit score development, pinpoint analysis of D-H borrowers around the country shows average incomes of around $35,000-$45,000 per family per year, with that income dropping off sharply as credit scores fall.

[14] I have collected anecdotal evidence on this for over twenty years from lawsuits and documents related to consumer complaints about BHPH sellers.

[15] Two other critical parts of 'special handling' cost are the costs of processing sub-prime loans and the costs related to collections. With D/E borrowers, the decline rate on loans is much higher, substantially driving up costs related to each application. It takes as much personnel and overhead to handle a declined loan as it does an approved loan, and of course the declined loans don't have an income stream attached to them. Collection costs for sub-prime loans are also much higher than for more conventional loans.

Figure 4. Credit Score Categories.



For instance, D/E borrowers in the two-year test at University Federal Credit Union in Austin, Texas, had an average gross income of about $45,000.[16] Car owners in the Working Wheels program study had an average gross income of $14,000 per year. [17] Though there are many definitions of ‘moderate’ and ‘low’ income, the $35-45,000 income range will very conservatively put us in the moderate and low-income categories in many areas of the country.[18]

The sub-prime auto-financing universe available to our target audience: Very big indeed. Virtually all of it bad. At minimum, the sub-prime auto financing market is a 100 billion dollar annual loan market.[19] This number is quoted extensively in the business, and the number is backed up by adding isolated bits of data from many companies' financial reports. One sub-prime company by itself, Americredit, put five billion dollars in sub-prime auto loans (probably over half a million loans) on its books in

[16] The income range at University Federal Credit Union may also be high. It includes some higher-income credit union members who simply had bad credit and therefore fell into the sub-prime credit risk categories. The UFCU sub-prime project involves over 2,000 D/E credit union loans over the past 22 months.
[17] Contacts at many consumer groups strongly disagree with my assumption in using only D credit scores and below to define ‘sub-prime.’ They correctly state that nearly a third of borrowers, those in the ‘C” credit score range, are many times forced to deal with sub-prime lenders. However, the income of many of these borrowers is considerably higher, which was the primary basis for my decision.
[18] We're generally using these definitions: Moderate income households are families having an annual gross income between 80 and 120% of area median income; low income families having an annual gross income under 80% of area median income. Ref. http://santa-monica.org/epd/scp/glossary.htm.
[19] Wards, Americredit, National Auto Finance Association (sub-prime), Credit Acceptance Corporation.

2005. This hundred-billion-dollar number does not include figures from BHPH companies, as I mentioned, perhaps the fastest growing segment of the industry.

How many sub-prime loans make up 100 billion dollars? Sub-prime sources don't release this number, but a very conservative guess would be a $12,000 loan amount (the higher the number, the lower the number of loans.) To give you perspective on that number, note that the average D/E loan amount given to D/E borrowers in the University Federal Credit Union test was $12,000.[20] Many of the non-profit groups report average loan amounts well under $3,000.[21]

But based on a $12,000 loan amount, at least 8.3 million consumers got sub-prime auto loans in 2005. The number is probably much closer to sixteen million consumers, but for the purposes of this study, we will use the 8.3 million-consumer scenario.[22]

Who are the sub-prime players?

The players are no longer clearly defined, and the universe is highly, highly fragmented by credit score categories. The roles of sellers, lenders, and loan facilitators are also co-mingling. "Sellers" are defined as those who have an economic interest in the vehicle. A seller can be a new-car dealer or a mom and pop used-car operation. Lenders are the parties taking the major risk of the credit transaction, and facilitators are largely sellers who do the final paperwork. Facilitators are paid a handsome cut for that effort.

- **Vehicle sellers.** Because of risked-based financing, and the relatively larger profit opportunities risked-based financing provides, all automobile dealerships long ago embraced the sub-prime arena. Vehicle sellers facilitate probably more than eighty percent of the sub-prime car loans per year.[23] They used to fund virtually none of it. Recently, however, some national seller chains reportedly have begun to provide funds for sub-prime lending pools.

  As we will see, new-car dealers are expanding their grasp in general sub-prime lending and moving quickly into BHPH lending. Most new-car franchises generally contract with multiple sub-prime lenders to provide funds for their standard sub-prime loans. For instance, Sonic Aviation, considered by some consumer groups (and the author of this study) to be one of the most aggressive and predatory new car dealership chains in the country, has partnered with WFS Financial Services to provide sub-prime paper to its 200+ dealerships. WFS has over $6 billion in auto loans on its books. Sonic has also purchased the 29 sub-prime dealerships in the First America chain. [24]

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[20] Detail of UFCU.
[21] UFCU evaluation of 2000 loans between July 2004 and May 1, 2006.
[22] UFCU numbers populated over all credit union population of 89 million would show over ten million sub-prime loans.
[23] A compilation of published data.
[24] Wards Dealer Business, October 2000.

New car manufacturers as well are forming multiple alliances to strengthen their sub-prime lending capabilities. For instance, DaimlerChrysler Financial partnered with Credit Acceptance Corporation for a test program at 37 D.C. dealerships.[25]

Major used-car companies such as AutoNation also are now aggressively seeking sub-prime paper arrangements.

An ominous development: Increasingly more new-car dealers are setting up their own car lots and payment schemes for BHPH sales. Traditionally, new-car dealers wholesaled their junker trade-ins (many of them going to mom-and-pop BHPH operators). The junker trades therefore weren't a profit item. Now the new-car dealers are taking that $500 or $1,000 junker and selling it on their own BHPH lots for $5,000, then adding a huge financing profit on top of that profit.

But whether the vehicle seller is a new or used seller, and whether the seller is a national new-car dealer chain or a mom-and-pop used car lot—the seller has always owned and controlled which financing option sub-prime consumers must use. They also have traditionally controlled who goes to what auto outlet—and that control is not going to change. Dealer advertising dollars and the mere fact that dealers have all the cars drive consumer traffic. Any large-scale help for the LMI borrowing community will have to involve finding a way to work with existing vehicle wholesale and retail selling organizations. By 'working with," I do not mean "partnering with." In my view, a partnership won't work. More on this later.

- **Banks.** Banks provide funding for under 30% of the sub-prime market through their various entities, or funding for about 1.8 million consumers.[26] Virtually all banks now make some higher-score sub-prime loans to long-time customers and regularly finance consumers who skirt the sub-prime threshold. Some national banks have specialized sub-prime lending programs; examples include BankOne, Wells Fargo, and Citibank. Many large banks also maintain their own separate sub-prime lending companies.

  An interesting definition of competition: the consumer loses. But because banks generally don't sell vehicles, their role is usually as an **indirect lender**: the consumer doesn't sign the bank loan at the bank; for instance, he or she signs the bank loan at the seller/facilitator's office. Most of the time the consumer doesn't know about the lending source until the loan papers are signed. The facilitator, of course, has chosen the loan company that offers the greatest profit to the facilitator.

  Banks (and for that matter all lending sources who provide loan options to the sellers/facilitators) therefore cater to the seller/facilitators, not to the consumers' best interest. Each lender is constantly competing with every other lending source

[25] Automotive News report.
[26] Banks control about thirty percent of the consumer lending universe in general.

for the dealers' business. The lender that pays the largest profit to the dealer, not the lender that gives the most favorable terms to the consumer, is rewarded with the dealers' business. This competition may be considered unethical by some consumer groups, but it is simply free enterprise at work.

- **Credit unions.** Credit unions currently provide funding for no more than 5% of sub-prime borrowers. In one of the great ironies of consumerism, credit unions, created to help working-class people, remain the last major institutional category largely to reject sub-prime lending. Credit unions have traditionally been strongly discouraged from entering this market by the National Credit Union Administration's very conservative lending guidelines. Credit unions are also generally run by conservative volunteer boards who move glacially when it comes to fiscal policy changes. Credit unions have also been last among financial institutions to move to risk-based financing. Without risk-based financing, sub-prime loans will not occur on a large-scale basis.

  The few credit unions who did move into sub-prime lending normally did it by simply outsourcing those loans to such sub-prime lenders as Centrix Financial, a Colorado-based company. Centrix's business model used credit unions to provide funds, while Centrix guaranteed payments. Centrix offered these loans to traditional vehicle sellers as sub-prime loans. [27]

  The National Credit Union Administration has recently derailed the Centrix model by issuing a "risk alert," which stopped all credit unions from using the company. As a consumerist, I believe the NCUA did LMI consumers a favor: the Centrix lending model, in my opinion, is counter to the strong credit union ethic of helping working-class consumers. The model also essentially turned the credit-counseling role over to sub-prime auto sellers, a classic definition of foxes watching henhouses.

- **Sub-prime lending companies and capital risk pools**. These companies and funds provide over 60% of sub-prime loans. [28] The number is probably irrelevant, because these groups have partnered with most of the other sub-prime lenders, from banks to insurance companies to vehicle sellers. Most of these companies are indirect lenders, providing loans that are closed at selling dealers' offices. These companies are driven by the same competitive zeal as all other indirect lenders—they are trying to design products that pay vehicle sellers larger profits than other financing companies.

[27] Credit Union Direct Lending (CUDL), the largest program designed to allow dealerships to become facilitators for credit union loans, has also entered the sub-prime arena, and appears to have a great interest in this area. CUDL is well established in the credit union community, and has partnerships with many state credit union leagues. But in my opinion, the CUDL model for normal lending procedures, much less for sub-prime lending, allows for great consumer abuse and encourages auto dealers to present themselves as 'partners' in the credit union mission of conserving members' assets. Dealerships are profit maximizers, not concerned with conserving the consumers' assets.

[28] Anecdotal data from various sources.

There are at least 26 major players in the sub-prime lending community and thousands of minor players.[29] In the past five years, several major sub-prime lending operators have incurred huge loan loses both from loan defaults and from the decline in value of defaulted vehicles.[30] Most of these defaults occurred because of faulty underwriting and because of the lenders' reliance on vehicle sellers to provide accurate customer credit and background information. The major lenders, for now, seem to have corrected most of their underwriting problems.

But their problems offer an important warning for those who want to enter the sub-prime vehicle sales/financing arena. It is a snake pit, dangerous for even the most experienced players. The danger largely comes from the overall dealer selling mentality: who cares what happens after the vehicle is sold? The dealership, except in the case of BHPH sales, has made virtually all of its profit at the time the loan is closed.

Companies such as Household Finance traditionally used to close loans at their own offices, but paid commissions to dealers for referrals. That model is changing. For instance, seven years ago HFC purchased Transamerica Financial Services, a subsidiary of Transamerica Corporation, and ACC Consumer Finance, a "leader in the sub-prime auto finance industry."[31] These companies are part of the sub-prime indirect lending subset.

- **Buy Here-Pay Here Finance/Vehicle Selling Schemes.** As sub-prime lending is to BHPH schemes, so is purgatory to hell. There's hope in the purgatory of legitimate sub-prime lending. An educated consumer can work their way out and eventually become "whole" in the credit sense. But in my opinion BHPH schemes as they are currently designed and run by the vast majority of for-profit players offer virtually no hope for the consumer. The vehicle will invariably be bad, vastly overpriced, and wildly over financed. Normally, the consumers with most need—those with F credit scores or worse and those without credit scores or social security numbers—live in this world. These consumers are also most likely the consumers served by non-profits and community-based groups.

  BHPH schemes finance vehicles in two ways. Some use traditional sub-prime lending sources for some customers. But the vast majority try to use the consumers' cash itself to 'finance' the consumers' purchases. We are concerned here with the latter category.

  I've mentioned one of the key problems with this scheme earlier. BHPH schemes by their very structure redefine "interest." Generally, these schemes do not place a

[29] Wards Business, Nov, 2005. Most trade press refer to 25-30 major players in the sub-prime market.
[30] Even national banks have incurred major losses in the sub-prime area, and all lenders constantly cite their losses as the justification for their rates. A close look shows that many of these losses occurred because the financed vehicles simply quit running and consumers walked away from them. The problem of vehicle condition isn't a risk factor that should increase interest rates, however.
[31] http://www.scripophily.net/housfincor.html.

selling price on a vehicle. Instead, the selling price is determined by the paying power of the consumer: "How much cash can you get me for a down payment?" (Money from relatives and friends is regularly suggested at some of these companies as a fine down-payment source). "How much money can you pay me a month?" The answer to those two questions determines the selling price. The practice is sometimes referred to as "backing out" the deal. While the interest rate listed on the finance document may be astoundingly high, it doesn't begin to cover the true interest rate. Because the consumer is financing, the selling price of the vehicle itself may be raised thousands of dollars, a raise solely based upon the consumers' ability to pay. This increase in selling price in effect amounts to additional "interest."

BHPH sellers not only survive with this selling mentality, they normally thrive. Why? Because the sellers are virtually always trying to get down payments which cover the sellers' investment in a vehicle. If you have access to $3,000 in cash, the dealers normally believe that you deserve a vehicle that costs the dealership no more than $3,000, and less, if possible. Everything the seller collects above that $3,000 as a monthly or weekly payment is lagniappe. [32]

And that lagniappe is made up of both excess profit on the vehicle and excess interest charges.

BHPH schemes seem poised for dramatic growth, as I have mentioned. National new-car chains within five years will probably be the largest players on this field. Generally speaking, most new-car dealerships would normally be happy with a bottom-line profit of about three percent of revenues on their general sales. Well-run BHPH schemes can regularly return 17-20% on revenue.[33]

Kenneth Shilson, "Founder and Convention Chairman of the National Association of Buy Here, Pay Here Dealers (NABD)," most succinctly states the case for prospective new-car dealers who are considering the BHPH model: "…new car dealers who enter the buy here, pay here business will likely find 'synergism' with their franchise operations," Mr. Shilson says. "For instance, older model used car trade-ins can be recycled into buy here, pay here operations where they can generate significant profits through resale. Such cars can be sold to sub-prime customers on lucrative installment note contracts instead of being disposed of at wholesale losses. In addition, customers who do not qualify for new car financing often make excellent sub-prime customers. Credit turn-downs often become desirable sub-prime customers."[34] Mr. Shilson, in an article for Dealer Marketing

[32] All vehicle lenders are of course interested in their equity position in every car. BHPH schemes, however, take that interest to a whole new level. BHPH dealers do face great risks, largely from the investment required to purchase inventory. While virtually all new-car dealerships 'floorplan' their vehicles, new and used, very few BHPH dealerships floorplan. If the vehicles go bad before they are sold (or if the seller doesn't have a proper equity position in the vehicle when it is sold), losses on individual units can be dramatic and in time catastrophic.
[33] National BHPH Association.
[34] Release by the BHPH National Association.

Center goes on to say the BHPH market is "…perhaps the most vital and active of the automotive sales industry.

"I think it's one of the most important segments, if not *the* most important, and it's definitely the most profitable," Shilson concludes.

For all these reasons, BHPH is entering the mainstream automotive community, and in that stream a successful tactic populates itself throughout the community in years, not decades.

How big is the BHPH universe? How many low-income consumers fall prey to BHPH schemes each year? The numbers aren't bandied around in public, and probably aren't known nationally. Two BHPH groups declined to provide any numbers, and a representative of one of these groups was "insulted" by our questions. Most mom-and-pop BHPH operators (who probably sell the vast majority of BHPH vehicles) may not belong to associations, and are invisible in the statistical world. Additionally, since most BHPH sellers don't normally report to credit bureaus which of their customers pay "as agreed," (and therefore probably don't help the consumers who paid as agreed to build their credit), we can't extrapolate the numbers from credit bureaus.

Just two of the BHPH players in 2001, before BHPH began to enter the mainstream auto consciousness as a real business option, sold/financed nearly 90,000 vehicles. Ugly Duckling sold over 26,000 vehicles at their dozen outlets, and JDByrider sold over 60,000 at their dozen company-owned outlets and 100+ franchise outlets. [35] And there are probably *over a hundred thousand BHPH operators,* virtually all of them flying below the radar. [36] Many of these operations may have only four or five cars. Many also "churn" their cars: sell the same car to several different buyers in one year. The business plan is simple—get your money out as quickly as you can, then repossess the vehicle the moment the buyer is a day late on a payment, and then sell the car again.[37]

- **Car ownership programs sponsored by non-profit community service-related organizations.** At least 150 of these programs provide extraordinary help to the individual consumers they come in contact with, and these programs have a hugely important role in working with consumers with the lowest or no credit scores. Each of these organizations should be encouraged to continue their good works, too.

  But it appears that no more than 24,000 vehicle transactions yearly are made by those 150 groups and the many church-related groups who provide vehicles for

[35] "Buy-here, pay-here dealerships flourish," *Automotive News*, November 25, 2002, and other articles.
[36] There are at least 24,000 communities in the United States, if you loosely define a 'community' as a population concentration. Even communities with a population of a thousand or less have mom and pop BHPH operators. Cities such as Los Angeles may have a thousand.
[37] "Churning" is endemic in the BHPH world, and has been the subject of several major class action lawsuits.

low-income consumers. If we are dealing with a low and moderate-income universe of between eight and sixteen million transactions per year, the community-service-related organizations are helping less than one third of one percent of the universe at best case.

The lack of significant numbers is driven somewhat by the lack of financial and organizational support for these organizations. But in my opinion, lack of support is not the major problem. The universe of low and moderate-income consumers in need of transportation solutions is so huge, and the transactions needed to help each individual consumer are so complex, that small organizations on their own are not going to be able to solve the problem.

Not-for-profits are not capable, thankfully, of operating as many used-car dealers—and, particularly, BHPH dealers—operate. Not-for-profits on a large scale are not trained for, or prepared to deal with, the highly complex issue of valuating used vehicles, particularly older used vehicles.

Is there a solution?

A caution: A large-scale, national, long-term solution for LMI consumers who need vehicles must work within the framework of both the auto industry's selling culture and the financial industry's profit structure, as I mentioned earlier.

However I do not believe the solution can include partnering with any part of the auto industry, whether that partnership is with vehicle sellers or with the majority of vehicle financers.

- The car-selling business model—whether it is a large new-car dealership or a mom and pop used car operation—is built on "opportunity pricing." Sellers and the majority of financers and virtually all of the facilitators believe they have the right to make more money on those who are not good negotiators. It is an unchangeable reality in the car business. Insecure and/or uneducated consumers will always be targets for extra-profit sales efforts.

- Even if a wholesale or retail vehicle enterprise wanted to offer some form of fixed car pricing and/or financing pricing for LMI consumers, the plan could not be implemented in the real world. Any plan would have to be accepted by the foot soldiers themselves—the individual sales persons and loan facilitators. It would be impossible to monitor foot soldiers and loan facilitators on a constant basis, and without that monitoring, no program would work.

I have spent over twenty years studying most aspects of the auto industry business, and one conclusion comes through again and again: problems in the auto sales and financing industry impact the consumer at the cellular level, at the contact point between each consumer and each seller/facilitator. We cannot control the many variables at that contact point. And the overwhelming pressure at that point is to maximize profit, to generally cover up bad things about individual vehicles, and to generally pressure the consumer to do what is best for the seller—not what is best for the consumer.

I believe, nevertheless, that a solution may be available. The solution is based on three premises:

- First, there are already plenty of good, older used cars in every community's used-car inventory. These cars can provide dependable long-term use—if consumers
  - know how to find them,
  - learn about their mechanical condition before buying them,
  - learn how to budget for necessary repairs,
  - learn how to negotiate for, and, finally,
  - learn how to maintain them.
- Second, selected existing financial institutions such as credit unions (financial cooperatives with a stated mission of conserving their owners wealth) can be educated to make responsible and profitable loans to LMI borrowers.
- Finally (and most importantly,) the long-term transportation solution that suffocates so many LMI consumers is primarily an *educational* problem, not a product problem. We don't need more lending sources, or more car lots, on the whole. Instead, we need to address several crucial opportunities for change.

A suggested approach to addressing the transportation needs of LMI consumers

First, organize a broad, nationwide coalition composed of non-profits and community-based groups, credit unions, elected officials and other groups interested in this specific issue. Coalition membership should not be automatic, and should be based on a proven record of concern for the LMI consumers' welfare.

The coalition should have some way of branding this initiative (much like a Good Housekeeping seal) so that consumers can learn to recognize a legitimate LMI lending program. Without this mechanism, some unethical lenders and facilitators of sub-prime loans, in my opinion, will take advantage of this program and will attempt to affiliate themselves with it.

This coalition or the appropriate foundation should be responsible for the development of all educational tools needed to reach both LMI consumers and other interested parties.

Second, redefine and expand the role of not-for-profits and community-based organizations in the LMI car/loan universe. The role of organizations such as Ways to Work (WTW) that provide a funding mechanism for very low-income consumers or provide cars themselves is a critical one. Literally millions of these consumers—those with F, G, and H credit, or with no credit scores or social security numbers—are beyond the reach of legitimate sub-prime loans even from a dedicated credit union with a strong desire to help.[38] These consumers simply cannot get a "conventional" sub-prime loan because they don't have a social security number or a credit score. WTW and other groups are a true lifeline in this circumstance.

But the role of WTW-type groups could and must go beyond their current, very limited programs. Although I haven't been asked to address this issue, let me briefly comment on some potential ways to increase these groups' impact:

- **Coordinate a national program to partner credit unions with groups such as WTW in various cities.** We could possibly partner this approach with some credit union leagues, and could certainly market it efficiently to the credit union movement and to the larger credit unions.[39]

- **Dramatically increase WTW-type access to existing lending sources such as credit unions.** For instance, use our new national coalition to sign up credit unions who might partner with WTW in administering guaranteed loan pools (how I refer to the WTW model.)[40]

- **Enlist all non-profits and community-based groups in a national education campaign about cars and LMI consumers.** As I mentioned, this problem is an educational problem. These groups could become the educational operatives in these areas:

    - *Educating lawmakers.* Simple changes in laws and regulations could dramatically help LMI consumers in the car arena. Many of the simplest changes would simply require data-gathering mandates. For instance, requiring credit reporting agencies to begin to tabulate payment records from buy here-pay here, rent-to-own, and other non-traditional payment

[38] Though the vast majority of persons with no credit score can't finance with credit unions and other more mainstream sources, careful loan underwriting by the institution may make some of these persons eligible for a loan. For instance, in the past 21 months, 300 consumers with no credit score applied for a car loan at University Federal Credit Union during the credit union's test of sub-prime lending. Fifty-two *were* approved for a loan.
[39] Footnote 35 applies to this comment, too. I have discussed the partnering idea with large and small credit union principals, and found them very inclined to such an effort.
[40] WTW will quickly tell you that credit unions haven't at all been cooperative in the past. I believe that can and will change, if credit unions are approached a bit differently.

collectors would allow the agencies (and other groups) to determine if these payments might be considered as credit-building payments.

- *Reaching out to LMI consumers, and particularly the low income consumers.* With presentations, videos and simple brochures, we need to reach these consumers before they go near a seller of cars. These consumers will listen, eagerly, if we can reach them with an alternative and simple advice. But if we don't reach them before they reach the dealership, we have lost them.

- *Educating the LMI consumer about the car buying process.* How do you find a good, cheap car? How do you know it is reliable? What should you pay, both for the car, and for money? Simple knowledge can have a huge impact in the car buying process.

- *"Graduating" very low-income consumers from the WTW model directly to a credit union sub-prime module of borrowing.* Credit unions, as they say, make loans one person at a time. If a WTW organization delivered ten loans a month to a credit union's already existing sub-prime lending program, the credit union would be grateful, particularly from an economic point of view.

▪ **Most importantly, enlist non-profits and community-based groups to help us develop data that could help establish the creditworthiness of consumers with no credit score**. As mentioned in footnote 5, the major reporting bureaus do not take into account payments made by consumers to BHPH car dealerships, rent-to-own companies, utility companies, and the like. In fact, the mere presence of BHPH and other payments on a person's credit report may lower a person's credit score. But these payments might be a good indication of credit worthiness, if enough data were available on a national basis. Some non-mainstream databases are beginning to collect this information, but much more pure data is needed. The development of a reliable scoring mechanism for consumers with payment histories based on non-mainstream items would be an historic step forward for LMI consumers.

The third major area of need if we are to solve the LMI transportation dilemma involves an education effort aimed at financial institutions. We need to develop the tools to educate major non-profit financial organizations such as credit unions about the potential benefits of a properly administered sub-prime lending program.

For the first time, we have a two-year test program at University Federal Credit Union in Austin, Texas that will in all likelihood provide us with the statistical data that may entice many credit unions. Preliminary data shows that the test program has been profitable. At the same time, it has provided these consumers with interest rates that are about ten percent less than rates at a traditional sub-prime lending organization.

A telling number: A thousand low and moderate income consumers a year with sub-prime credit have been successfully taking advantage of the UFCU lending program—without any marketing or advertising effort on the part of the credit union. The program has received no publicity. But if the national credit union movement undertook the same program, credit unions alone would be making over eight million loans a year to LMI consumers who now must turn to much less attractive lending sources. We are many years away from that level of participation, because of the stately pace of the credit union decision process. But very substantial numbers could happen relatively quickly.

The credit union movement has a strong vested interest in entering the LMI loan marketplace. The tax-exempt status of credit unions is under strong attack by the general banking community. The proper LMI loan program can substantially help credit unions reclaim and/or cement their role as advocates for working class Americans.

I recommend that credit unions and any other financial institutions who want to join this program must be certified in some way to participate.

Fourth, we must provide credit unions with a turnkey D-E business plan, an outreach plan, and a staff training plan. Most non-profit financial institutions are not going to participate in sub-prime programs without extensive business coaching. (In a moment we will deal with F-H credit scores and lower).

The business plan for credit unions' might include

- An outreach program to assist credit unions in forming partnerships with community-based groups and other WTW-type organizations.
- Of course, membership in the credit union, and access to both checking and savings accounts.
- A procedure for D/E consumers to have vehicles checked by a mechanic, and for repairs to be incorporated in the loan.
- Some form of service agreement or forced repair savings plan which would be used to repair the vehicle or would be turned over to the consumer at the end of the loan.

- Alternatively, a savings plan tied to or incorporated in payment formulas. A small portion of each payment could be deposited into a savings account.

- A financial counseling and education element. This element could be coordinated and done largely by community-based groups partnering with credit unions.

- A 'reward' mechanism that holds out the promise of lower interest rates on the next loan if sub-prime consumers make their payments "as agreed."

The "credit union movement" encompasses many players. I am a former national spokesperson for the CUNA's (the Credit Union National Association's) car educational efforts. I also literally wrote the book for CUNA on how credit unions should educate their members about the car buying process.

I am also a critic of CUNA, of many credit unions, and of many credit unions' practices. But I believe the national involvement of the credit union movement is critical if the LMI car dilemma is going to be addressed in a meaningful way.

Fifth, the consumer movement needs to spearhead the development of a non-mainstream credit reporting system that could be used as an alternative to the mainstream credit reporting agencies. Life improves dramatically the moment a low-income consumer receives even a modest credit score. As we have seen in the University Federal Credit Union test, simply raising your credit score from "F" to "E" may allow a consumer to finance a vehicle at a credit union rather than purchase one from a Buy Here-Pay company. That, literally, is a life-changing moment. And many times the Buy Here-Pay Here customer may already have payment habits that would qualify that customer for the dramatically better credit union loan.

But most of these consumers don't make the type of payments that are considered valid for establishing credit. As mentioned in this report, several groups have been working on credit reporting models based on payments of rent, telephone bills, and other items not currently included in mainstream credit reports. Right now, none of these groups have the proper funding and staffing to gather and analyze the data necessary to develop such systems.

Sixth, the Buy Here-Pay Here phenomenon should be studied in depth. The story of low-income consumers in particular (as opposed to moderate income consumers) is rapidly becoming the story of BHPH operations, and we know little about these operations, even though they impact probably millions of consumers.

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A final ten second summary of this report: Each member of each LMI family is severely impacted for years by the lack of meaningful assistance in the car-buying process. The solution to the problem is educationally based, and the players to solve the problem already exist.

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