Subprime Auto Loans

The Rising Menace of Wall Street's Latest Darling

by Jeff Kirk*

Barely six years after the subprime-mortgage lending crisis threatened to implode the American economy, Wall Street is at it again. The nation's biggest banks, hedge funds, and private equity groups are fueling a new wave of subprime borrowing, to the tune of hundreds of billions of dollars. This time, however, mortgages are not the focus; instead, subprime auto loans have emerged as the hot new investment vehicle of the moment. According to the Federal Reserve Bank of New York, the number of subprime auto loans issued to borrowers doubled between 2009 and 2014.[1]

As was the case with subprime mortgages, today's subprime auto loans are being bundled by the thousands and collateralized into bond instruments that are sold off in pieces to the highest bidders, generally investors seeking double-digit returns in a market where interest rates on whole hover stubbornly close to zero. Despite the inherent issues in trading complex securities similar to the ones that sparked a worldwide recession, Wall Street has been successfully marketing these bonds to even the most stalwart institutional investors, including insurance companies and public pension funds.[2] On the flip side, subprime auto loans offer substantially reduced risk levels in contrast with subprime mortgages, thanks in no small part to the comparative ease of gaining repossession of a vehicle versus a domicile.

Despite the fact that subprime auto loans give formerly "untouchable" borrowers an opportunity to purchase vehicles once entirely out of reach, they nonetheless rankle consumer advocates for a simple reason: subprime loans target some of the nation's most desperate and least financially savvy consumers, many of whom have experienced extended periods of dire financial straits, and they are offered at interest rates often bordering on usurious. As a result, consumer advocates are questioning whether further regulation of this burgeoning industry is needed, and if so where the tipping point between protecting consumers and potentially reducing—or even cutting off—their access to auto loans lies.

NATURE OF THE BEAST: SUBPRIME LENDERS AND THEIR PREY

Broadly speaking, a subprime borrower is a consumer with a credit score below 600, and the auto loans they are effectively forced to use—if only because the alternative is usually not having a car, period—can have annual interest rates approaching 30 percent.[3] Numerous actions can lead to a consumer developing a subpar credit record, but they generally involve periods of acute financial distress owing to the failure of a business or a marriage, or in many cases an unexpected family illness not covered—in part or in full—by health insurance.[4]

Contrary to popular belief, myriad means exist for decimating one's credit score aside from actions as drastic as declaring bankruptcy, including failure to make continuous on-time payments for credit cards with a revolving balance. Furthermore, the short sale of a home—which involves paying the lienholder(s) of a mortgage less than the balance due—is just as detrimental to a consumer's credit score as declaring bankruptcy, according to FICO.[5]

While subprime mortgages and subprime vehicle loans differ substantially, one difference in particular is simple but key: a consumer can forego purchasing a home and rent one, but car ownership is a requisite for an overwhelming majority of American households.[6] An estimated 91 percent of American adults commute to work using their personal vehicles.[7] In most cases these drivers lack any other reasonable transport option; on average, only 27 percent of American jobs are accessible via public transit service in less than 90 minutes, and nearly half of the residents of the suburban South—including people residing in the Houston, Dallas, and Austin suburbs—have no access to public transportation of any sort.[8] Even for poor-credit consumers who can get by without making a monthly housing payment—in many cases because they are cohabitating with family or friends—ready access to a car is often an absolute necessity.

Enter the subprime auto lender. The difference between home and auto loans is key from a lender's perspective as well: home foreclosure is inevitably a messy process, and often one that cannot be completed without going through state-level courts.[9] In contrast, a lender seeking repossession of a motor vehicle can not only do so absent judicial intervention[10]; in many cases they can take constructive possession without leaving their desks. Modern technology has given lenders the ability to disable vehicles via any computer or smartphone with Internet access. So-called "driver-interrupt devices" allow both lenders and "repo men" to disable a car at the click of a mouse button until any outstanding loan balance has been paid, and they are increasingly being installed in vehicles purchased with subprime loans.[11] Despite numerous complaints about the devices, auto dealers typically respond by noting that borrowers nearly always assent to their installation.[12] They also point out that "constructive repossession" is much less stressful and embarrassing than actual repossession, which often involves a forcible vehicle removal at a borrower's home and a trip to a repo yard to regain possession, coupled with a hefty repo fee.[13]

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FEEDING THE BEAST: LENDERS AND THEIR AMPLE INVESTORS

While banks specializing in subprime auto loans dominate the industry—one such bank, Santander Consumer USA, financed nearly one-quarter of all subprime car loans in the first half of 2014[14]—many of America's biggest traditional lending institutions are also significant players in the game. Wells Fargo, for instance, manages a total of over $50 billion in auto loans, and in 2013, 17 percent of its loans were given to consumers with credit scores of 600 or less.[15] Further, the dollar amounts fueling the industry as a whole are staggering. As of the first quarter of 2014, American consumers had outstanding auto loans valued at nearly $900 billion,[16] and 27 percent of the loans originated in 2013 were subprime in nature—a rise of 130 percent since the aftermath of the 2008 financial crisis.[17]

Collateralized subprime auto-loan instruments have proven appealing to an investor base well beyond the norm. Thanks to their high returns-on-investment—at a time when most auto loan-backed securities yield returns of only one percent to four percent[18]—and substantially lower risk levels in contrast with subprime mortgages, the new loan vehicles are being backed by groups ranging from private equity firms to credit unions.[19] On top of that, Wall Street banks are securitizing subprime auto loans in nearly the same fashion they once did with subprime mortgages. After collectively pooling thousands of auto loans into a single instrument, the banks divvy it up and sell its pieces to the likes of hedge funds and high-yield mutual funds. In effect, any buyer with an appetite for (marginal) risk in return for sizable returns is fair game. As one example, Prestige Financial Services of Utah recently offered a $390 million bond issue of bundled subprime loans with an average interest rate of 18.6 percent. Investment orders for the deal exceeded the amount available for sale by 400 percent.[20]

These buying frenzies are taking place despite the inherent risk of an unexpectedly large number of defaults at around the same time—precisely the turn of events that sparked the 2008 economic crisis.[21] Nonetheless, purchasers of collateralized subprime auto-loan instruments are presumably betting that this risk is outweighed by the reward of double-digit returns. Also, the sheer necessity of car ownership as described above precludes the possibility of a huge decline in overall sales, and in turn reduces levels of risk exposure for bond investors. Even though purchases of brand-new vehicles often decline precipitously during recessions, the total number of vehicles on the road typically remains roughly the same.[22]

As another example of an unsettling similarity with the subprime mortgage boom, bond rating agencies are bestowing these new collateralized auto-loan instruments with their highest marks. Prestige's recent bond offering, for instance, received a triple-A rating from Standard & Poor's, and a similar one the company offered in 2013 yielded the same S&P rating.[23] Nonetheless, buyers of such bonds in general have no viable means of vetting the information bond issuers provide them. As one former analyst put it, "[i]nvestors are basically taking the issuer's word that they follow certain procedures," noting that such a practice leaves ample opportunity for fraud.[24] The question remains, however, whether this possibility will deter investors eager for high-yield returns.

REINING IN THE BEAST: CONSUMER ADVOCATES STRIKE BACK

The subprime auto loan industry has historically proven difficult to police, particularly because high-interest-rate loans are generally legal under state and federal law. Nonetheless, a coalition of city, state, and federal agencies has been taking aggressive steps as of late to rein in subprime lending practices.

The Consumer Financial Protection Bureau—created as part of the Dodd-Frank Wall Street Reform and Consumer

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Protection Act of 2010, which established a series of consumer protections in the wake of the 2008 economic crisis—has been aggressively pursuing subprime lenders for their anti-consumer loan practices. In September, for instance, the Bureau proposed direct federal oversight of nonbank auto finance companies for the first time, which would include entities like GM Financial as well as other automakers' financing arms.[25] The CFPB has also targeted multiple subprime lenders for violations of the so-called "Furnishers Rule," an element of Dodd-Frank that requires lenders to provide accurate consumer data to credit reporting agencies. In November, for example, the Bureau announced a consent order with the financing arm of Phoenix-based DriveTime—a nationwide used-car franchise—for violating the Rule, including an $8 million penalty.[26]

The CFPB has company in its federal ranks: the Justice Department and its many arms have subprime lenders in their sights as well. The U.S. Attorney for the Southern District of New York is scrutinizing whether GM fully disclosed the creditworthiness of subprime borrowers to investors who purchased stakes in its collateralized loan instruments.[27] Additionally, in Alabama, a U.S. Attorney secured a grand jury indictment last summer against a Birmingham auto dealer, alleging multiple counts of conspiracy and fraud for falsifying customer loan applications.[28] Worsening matters further for the industry, the Securities and Exchange Commission has piled on it as well. In October Ally Financial—now the nation's largest auto lender[29]—announced that it, too, was under SEC investigation for its loan-collateralization practices.[30]

Adding to the mix, state- and municipal-level agencies are putting significant pressure on the industry's lending practices in areas outside of federal purview. In November, for instance, the New York City Department of Consumer Affairs announced that it had issued subpoenas to two subsidiaries of Santander, seeking to determine whether used-car dealers were misleading low-income car buyers by failing to disclose various "fees" hidden in the fine print of their purchase contracts.[31] Further, banking giant Capital One quietly disclosed in its latest 10-Q filing that the New York District Attorney's Office has been investigating its subprime lending practices.[32] At this point one can wonder whether subprime auto loans constitute a legitimate though flawed business, or a house of cards on the verge of collapse.

CONCLUSION

The subprime auto loan industry is booming, thanks in large part to the millions of Americans whose low credit scores deter them from financing a vehicle purchase any other way. The question remains, however, how long this latest "car rush" will last. The industry is taking hits from myriad sources—city, state, and federal agencies alike—and regulators across the board appear determined to keep this investment vehicle from rolling out of control. Still, one hopes that a happy medium between two extremes—helping down-on-their-luck consumers obtain auto loans that would otherwise be out of reach, and manipulating desperate consumers into signing fraudulent and financially deleterious auto-purchase contracts—can ultimately be found.

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3 Michael Corkery & Jessica Silver-Greenberg, *Miss a Payment? Good Luck Moving That Car*, N.Y. Times: DealBook (Sept. 24, 2014, 9:33 PM), http://dealbook.nytimes.com/2014/09/24/miss-a-payment-good-luck-moving-that-car/.

4 Over 60 percent of personal bankruptcies come as a result of medical bills. *See, e.g.*, David U. Himmelstein, MD et al., *Medical Bankruptcy in the United States, 2007: Results of a National Study*, American Journal of Medicine, Aug. 2009, at 741-746, *available at* http://www.pnhp.org/new_bankruptcy_study/Bankruptcy-2009.pdf.

5 Michelle Singletary, *What's Worse for Credit Score—Foreclosure, Short Sale or Deed in Lieu?,* Wash. Post, Aug. 30, 2011, *available at* http://www.washingtonpost.com/business/economy/whats-worse-for-credit-score--foreclosure-short-sale-or-deed-in-lieu/2011/08/30/gIQAbnTaqJ_story.html.

6 For purposes of discussion, I am including auto leases as a de facto means of ownership. While one can obviously lease a home as well, an auto lease bears much more in common with a traditional auto loan than a home lease, including a fixed interest rate and a term generally ranging from 36 to 72 months.

7 National Consumer Law Center, Consumer Credit Regulation § 10.3.1.1 at 447 n.53 (citing U.S. Dep't of Transp., Bureau of Transp. Statistics, NHTS 2001 Highlights Report, BTS 03–05 (Washington, D.C. 2003)).

8 Adie Tomer, Metropolitan Policy Program, Brookings Institution, *Where the Jobs Are: Employer Access to Labor by Transit* (2012).

9 As of this writing, 22 states require judicial foreclosures. *See, e.g.*, Mortgage Bankers Association, *Judicial Versus Non-Judicial Foreclosure*, http://www.mbaa.org/files/resourcecenter/ foreclosureprocess/judicialversusnon-judicialforeclosure.pdf.

10 *See* U.C.C. § 9-609(b) (2002).

11 Corkery & Silver-Greenberg, *supra*.

12 Robert Szypko, *Your Car Won't Start. Did You Make the Loan Payment?*, NPR (Oct. 16, 2014), http://www.npr.org/blogs/alltechconsidered/2014/10/16/356693782/your-car-wont-start-did-you-make-the-loan-payment.

13 *Id*.

14 Jim Henry, *After Probe of Santander, GM Financial, Who's Next Among Subprime Auto Lenders?*, Automotive News (Aug. 8, 2014), http://www.autonews.com/article/20140808/ FINANCE_AND_INSURANCE/140809801/after-probe-of-santander-gm-financial-whos-next-among-subprime-auto.

15 Silver-Greenberg & Corkery, *supra*.

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19 Corkery & Silver-Greenberg, *supra*.

20 *Id*.

21 Silver-Greenberg & Corkery, *supra*.

22 *See* Kelsey Mays, *Why Used-Car Prices Will Remain High*, Cars.com

(May 23, 2012), http://blogs.cars.com/kickingtires/2012/05/used-car-prices.html (the total number of cars on American roads declined only negligibly, from 241 million to 240 million, as a result of the economic crisis).

23 Silver-Greenberg & Corkery, *supra*.

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