BerkeleyLaw
UNIVERSITY OF CALIFORNIA
Berkeley Center for Law, Business and the Economy

University of California, Berkeley
School of Law
2850 Telegraph Ave, Suite 500
Berkeley, CA 94705-7220

Ph: 510.642.0532 – Fax: 510.643.7095
E-mail: BCLBE@law.berkeley.edu
http://www.law.berkeley.edu/bclbe.htm

Regulators Turn to Subprime Auto Lending

By Yu Tanebe, J.D. Candidate 2017 | February 13, 2015

The Federal Trade Commission (FTC) announced on January 30 that it reached a settlement with two companies engaged in subprime auto lending. The two car title lenders – First American Title Lending and Finance Select – were alleged to have misled borrowers in their advertisements by failing to disclose the actual terms and costs of loans.

Car title loans involve owners borrowing money against their cars – usually receiving a percentage of the car's estimated resale value – by exchanging car titles as collateral for cash. As regulators in a number of states have cracked down on payday loans, title loans have become an increasingly prevalent form of short-term credit. According to the Federal Deposit Insurance Corporation, more than 1.1 million US households reported taking out an auto title loan in 2013. Roughly 20 percent of borrowers use the title loans to cover mortgage or rent payments.

These loans can have severe financial consequences for many Americans who don't realize how much they truly cost. Effective interest rates can range from nearly 80 percent to over 500 percent. Loan terms are typically 30 days, but borrowers who are unable to pay the full loan and interest payments are forced to renew the loans at the end of each month, incurring additional fees. According to an analysis by the Center for Responsible Lending, one in six title loan borrowers lost their cars to repossession. Further, the average borrower pays $2,142 in interest for just $951 in credit.

First American Title Lending and Finance Select advertised title loans with zero percent interest for 30 days. However, the advertisements failed to disclose that the offers required borrowers to meet a host of conditions. For instance, borrowers were not told that they would have to repay the loans in 30 days, or that payments had to be made using certified funds, as opposed to cash or personal checks. Borrowers who failed to meet these conditions would not qualify for zero percent interest, and would be charged additional fees. The advertisements also did not disclose the interest rate that would apply if a borrower did not qualify for the offer.

As part of the settlement with the FTC, the companies agreed to improve their disclosures about loan terms. Although the companies escaped regulatory fines, they can face penalties of up to $16,000 for each violation.

This is the first time that the FTC has taken action against title lenders, based on a growing concern among state and federal authorities that the loans are pushing some of the most vulnerable borrowers further into debt, plunging them into bankruptcy, and in many cases, costing them a vital necessity – their cars.

Subprime lending by its nature involves evaluating the creditworthiness of borrowers who may have had financial difficulties in the past, such as bankruptcy or foreclosure. Lenders, though, are increasingly basing their loan decisions on an assessment of the used car's resale value, and not

BerkeleyLaw
UNIVERSITY OF CALIFORNIA

Berkeley Center for Law,
Business and the Economy

University of California, Berkeley
School of Law
2850 Telegraph Ave, Suite 500
Berkeley, CA 94705-7220

Ph: 510.642.0532 – Fax: 510.643.7095
E-mail: BCLBE@law.berkeley.edu
http://www.law.berkeley.edu/bclbe.htm

on the ability to repay. Further, the title lending industry thrives because of the centrality of the car in people's lives. A car is vital to participating in the work force, and lenders are betting that people will choose to make auto loan payments before paying for other expenses, including mortgages.

With the mortgage-backed securities market frozen after the financial crisis, many investors are also enticed by the high interest rates on the loans. Thousands of subprime auto loans are bundled together and sold as securities to insurance companies, mutual funds, private equity and hedge funds. According to Thomson Reuters IFR Markets, such securitizations have grown 302 percent since 2010, and 28 percent from 2013.

One potential danger is that lenders may be encouraged to lower their credit standards in order to initiate enough loans to keep up with investor demand. Such a broad loosening of credit standards across the subprime auto industry could initiate a vicious cycle allowing excessive risk to creep into the market. Credit rating firms like Standard & Poor's have already voiced concern about the declining quality of the loans backing the investments.

Some experts contend that subprime auto lending is unlikely to cause another subprime financial crisis. For one thing, the overall auto loan market, at $900 billion, is comparatively small compared to the $8 trillion mortgage loan market. Further, subprime lending constitutes just 30 percent of car loans, and car loan defaults have historically remained relatively low.

Still, delinquencies on auto loans of 60 days or less are rising, and more Americans are losing their cars each month to repossession. According to Experian, 60-day loan delinquencies rose 8.6 percent in the third quarter of 2014, compared to the previous year.

Regulating the industry largely falls to state authorities. Lawmakers in some states have called for stricter regulation of title loans, but have been met by fierce lobbying. While many states now restrict payday loans, which share many of the same features as car title loans, the latter market has so far escaped a similar crackdown.

Twenty-one states expressly permit car title lending, allowing lenders to charge interests of up to 300 percent a year. In most other states, lenders can make loans with cars as collateral at lower interest rates. And even in states that restrict title loans, title lenders have found workarounds. In California, the interest rates and fees that lenders can charge on loans for $2,500 or less are restricted; in response, lenders have extended loans for amounts slightly above that threshold amount.

The high demand for subprime auto securities has led to another troubling development: an increase in loans containing falsified income or employment information. The US Department of Justice is currently investigating whether such faulty information ended up in securitization deals.

BerkeleyLaw
UNIVERSITY OF CALIFORNIA
Berkeley Center for Law, Business and the Economy

University of California, Berkeley
School of Law
2850 Telegraph Ave, Suite 500
Berkeley, CA 94705-7220

Ph: 510.642.0532 – Fax: 510.643.7095
E-mail: BCLBE@law.berkeley.edu
http://www.law.berkeley.edu/bclbe.htm

Given that subprime borrowers are vulnerable to predatory practices, and the potential ramifications of excess risk in the market, direct oversight of subprime auto lending practices – either by state regulatory agencies or the Justice Department – may be essential for both consumers and the wider economy.