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The Automobile Lending Market and Policy Issues

An automobile (auto) loan allows a consumer to finance the purchase of a new or used car. In most parts of the United States, access to a car is critical for people to be able to get to work and other important activities. According to Kelley Blue Book, a vehicle valuation and research company, the average cost of a new car was more than $36,000 in 2018. Most people cannot pay such a large amount in cash. For this reason, many people choose to finance the cost of a car.

The auto loan market is the third-largest consumer credit market in the United States, after mortgages and student loans. According to the New York Fed, at the end of 2018, 113 million consumers—roughly 45% of adult Americans—had an auto loan and auto loan debt outstanding totaled almost $1.3 trillion. This In Focus provides a brief overview of the auto lending market, explains how the market is regulated, and analyzes related policy issues.

Overview of the Auto Lending Market

Auto loans are usually structured as installment loans, where a consumer pays a fixed amount of money each month for a predetermined time period, frequently three to seven years. Often, lenders require consumers make a down payment to obtain the loan. Auto loans are secured by the automobile, so if a consumer cannot pay the loan, the lender can repossess the car to recoup the cost of the loan.

Reportedly, most auto loans are arranged at the auto dealership where the car was purchased, called the *indirect auto financing market*. The dealer forwards information about the prospective borrower to one or more lenders, and solicits potential financing offers. Often, the dealer is compensated for originating this loan through a discretionary markup, which is the difference between the lender's interest rate and the rate that a consumer is charged. The lender may cap the possible size of the dealer markup (e.g., 2.5%) to limit the loan from becoming too susceptible to default. But within this range, auto dealers and consumers can negotiate the loan's interest rate, and therefore indirectly determine how much to compensate the auto dealer for the convenience of arranging the loan.

In the indirect auto financing market, the dealer markup arrangement can incentivize the auto dealer to negotiate—and profit from—a higher interest rate with the consumer. The auto dealer may also choose the lender who compensates it the most—for example, the lender that allows the largest markup, rather than the lender offering the best terms for the consumer. Although other consumer credit markets include markups, it is less common for bank or credit union lenders to allow an outside broker in the transaction discretion as to the amount of the markup. For example, while the Real Estate Settlement Procedures Act restricts such practices in the mortgage market, after reports of mortgage brokers steering customers to more expensive loans due to "kickbacks"—unearned fees for a referral—in the lead-up to the financial crisis, Congress in 2010 took actions to further crack down on these practices.

Alternatively, consumers can also go directly to a bank, credit union, or other lender for an auto loan, before making their purchase, avoiding the dealer markup cost. Different consumers may prefer arranging auto financing through an auto dealer or directly through a lender, depending on their preferences around convenience, cost, and other factors. In either case, the lender usually owns the loan and can service it themselves or through a third-party company.

Some auto dealerships extend credit themselves, called "Buy Here, Pay Here," commonly marketing to consumers with subprime or no credit history. These dealers do not work on behalf of other lenders, but keep the loan on their books. These dealers tend to offer higher interest rates and more expensive loans to consumers.

If a consumer cannot pay cash for a new or used car, the consumer also has the option to lease the car. In a leasing arrangement, the consumer pays for the right to drive the car for a fixed period of time, often three years. Unlike an auto loan, the consumer does not own the car. Leasing arrangements are not considered consumer loans and, therefore, are not regulated like auto loans.

Auto Market Regulation

In response to the financial crisis, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank; P.L. 111-203) established the Bureau of Consumer Financial Protection (CFPB) to implement and enforce federal consumer financial law while ensuring consumers can access financial products and services. The CFPB's authorities fall into three broad categories: *supervisory*, including the power to examine and impose reporting requirements on financial institutions; *enforcement* of various consumer protection laws and regulations; and *rulemaking*, to prescribe regulations to implement consumer protection laws. The CFPB is the main federal regulator for the auto loan market, overseeing consumer protection compliance. If a bank or credit union owns auto loans on its books, that bank is also subject to safety and soundness regulation from other financial regulators, depending on its charter. For more information, see CRS In Focus IF10031, *Introduction to Financial Services: The Bureau of Consumer Financial Protection (CFPB)*, by Cheryl R. Cooper and David H. Carpenter.

The CFPB oversees consumer protection compliance for auto lending, but not auto dealers' typical activities. Dodd-

Frank states that the CFPB "may not exercise any [authority] over a motor vehicle dealer that is predominantly engaged in the sale and servicing of motor vehicles, the leasing and servicing of motor vehicles, or both." Given the major role that auto dealers play for consumers in dealer-arranged financing, Congress continues to debate the scope of the CFPB's regulatory jurisdiction over auto dealer activities.

Among other laws, the CFPB is responsible for enforcing the Equal Credit Opportunity Act (ECOA; 15 U.S.C. §§1691-1691f), which generally prohibits discrimination in credit transactions based upon certain protected classes, including an applicant's sex, race, color, national origin, religion, marital status, age, and "because all or part of the applicant's income derives from any public assistance program." ECOA historically has been interpreted to prohibit both intentional discrimination and *disparate impact* discrimination, in which a facially neutral business decision has a discriminatory effect on a protected class. However, the Supreme Court's reasoning in a June 2015 decision involving the Fair Housing Act, another federal antidiscrimination law, has sparked debate about whether disparate impact claims are covered under ECOA. For background on disparate impact claims, see CRS Report R44203, *Disparate Impact Claims Under the Fair Housing Act*, by David H. Carpenter.

Policy Issues

This section highlights selected policy issues of congressional interest in the auto finance market. In general, these policy debates concern the appropriate balance between consumer protection, convenient credit access for consumers, and costs to industry.

Consumer Awareness and Ability to Negotiate Auto Loan Terms. According to CFPB research, unlike car prices, consumers are not always aware that they can negotiate the terms of an auto loan when obtaining dealer-arranged financing. For this reason, many consumers do not shop for auto loans. Consumers' lack of awareness—combined with auto dealers' discretion on markups—may make consumers vulnerable to bad actors in this market and make the auto loan market uncompetitive. Some observers believe that financial education programs may be one way to raise consumer awareness of their right to negotiate the terms of an auto loan.

Fair Lending and Indirect Auto Lenders. In 2013, in response to concerns that auto dealer markups could result in pricing disparities based on protected classes, the CFPB issued a controversial bulletin providing guidance to indirect auto lenders on how to comply with ECOA. This guidance generally stated that indirect auto lenders should impose controls on or revise and monitor dealer markups to ensure they do not result in disparate impact based on race or other protected classes.

From 2013 to 2016, the CFPB, in coordination with the Department of Justice, issued consent orders to settle enforcement actions against American Honda Finance Corporation, Toyota Motor Credit Corporation, Fifth Third Bank, and Ally Financial & Ally Bank for ECOA violations in indirect auto lending markets. Auto lenders generally do not collect information on the race or ethnicity of borrowers. Using a new proxy methodology, a statistical method developed for estimating race, the CFPB generally alleged that these institutions violated ECOA by permitting their dealers to charge markups that resulted in disparate impacts on the basis of race and national origin. In general, as part of the consent orders these institutions did not admit or deny the allegations but, among other things, paid monetary penalties and agreed to limit their markups to reduce these disparities.

The CFPB's indirect auto lender guidance and the resulting enforcement actions were controversial. Some argued that the guidance overstepped Congress's intent in excluding auto dealers' typical activities from the CFPB's regulatory jurisdiction in Dodd-Frank. Others argued that the markup disparities were justified by legitimate business reasons. For example, auto dealers sometimes initially retain some default risk before transferring it all to the lender, which may explain some of the markup disparities. Yet, the CFPB argued that a change in indirect auto lenders' business models could reduce disparities while still being profitable for auto dealers by allowing, for example, a flat fee to the dealer for arranging the loan. Moreover, because the CFPB issued guidance, rather than a formal rule, without providing time to comply, some believed that the enforcement actions were unfair. In 2018, Congress rescinded the CFPB's indirect auto lender guidance pursuant to the Congressional Review Act (P.L. 104-121). Nevertheless, some observers argue that this policy issue continues to be an area of concern in the market.

Regulatory Exclusion. As previously mentioned, Dodd-Frank expressly excluded auto dealing, servicing, and leasing from the CFPB's regulatory jurisdiction. The scope of this exclusion continues to be controversial, given the key role auto dealers play in originating auto loans for a large part of the market. Auto dealers argue that because they are facilitating, not originating, auto loans—and their primary role is buying and selling cars—it is inappropriate to subject them to consumer financial protection regulations. Conversely, consumer advocates believe that, without direct government oversight, consumer protection violations will take place more frequently.

Longer Auto Loans Maturities. According to the CFPB, 26% of auto loans originated in 2009 matured in six or more years, whereas such loans constituted 42% of originations in 2017. While this trend has been attributed in part to rising vehicle costs and consumers retaining their cars longer, these factors may not fully account for the trend. If consumers are keeping their cars for longer periods of time, perhaps due to better vehicle technology, then longer loan terms may just reflect this improvement. However, if a consumer is ready to trade in for a new car before the end of the loan term, the consumer may owe more on the car loan than the vehicle is worth, called negative equity. Greater negative equity makes loans more susceptible to default. Notably, negative equity in the auto trade-in market has been increasing and is a common cause of consumer complaints to the CFPB.

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