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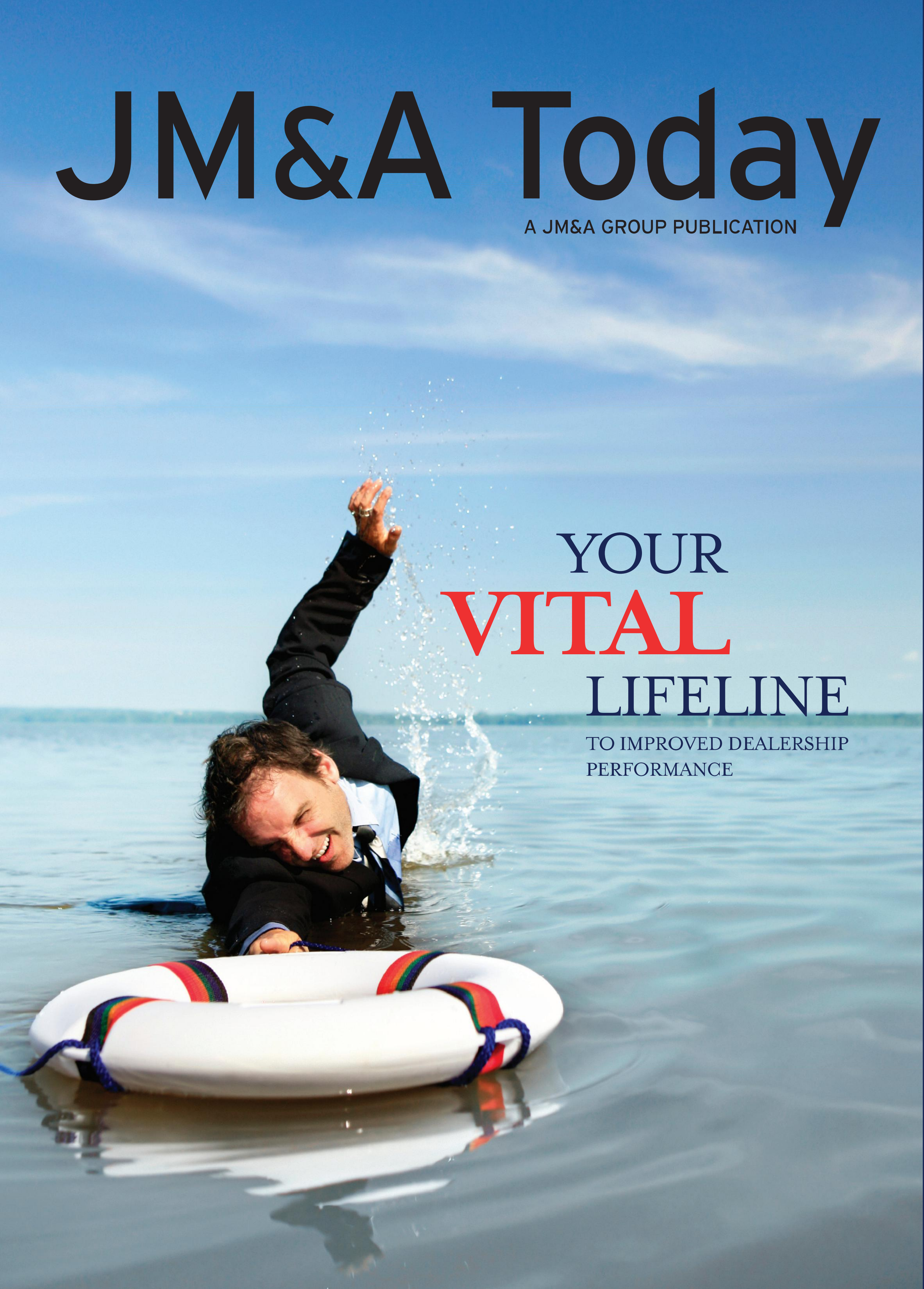

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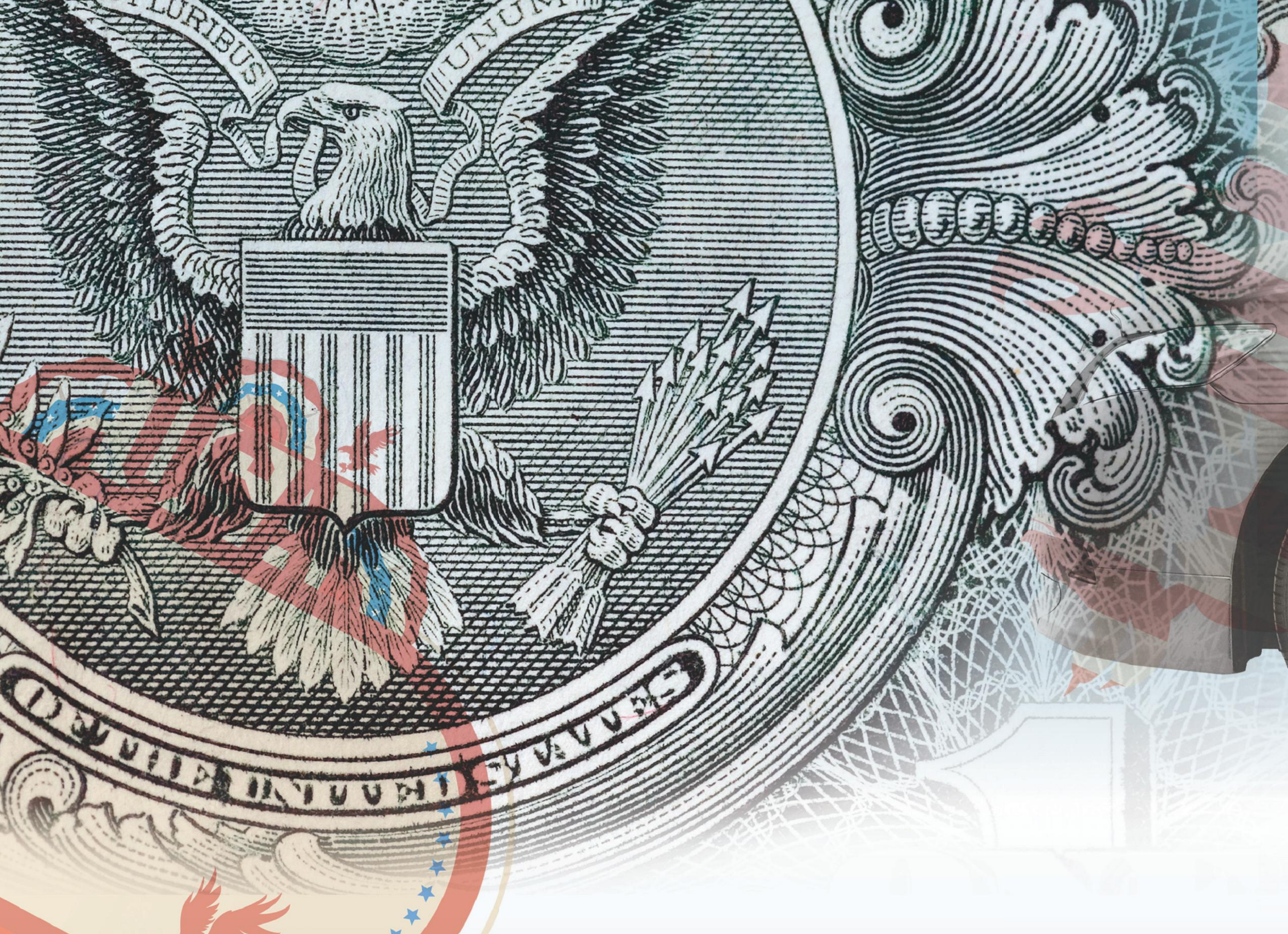


Predatory Lending

FACT OR FICTION IN THE AUTO INDUSTRY

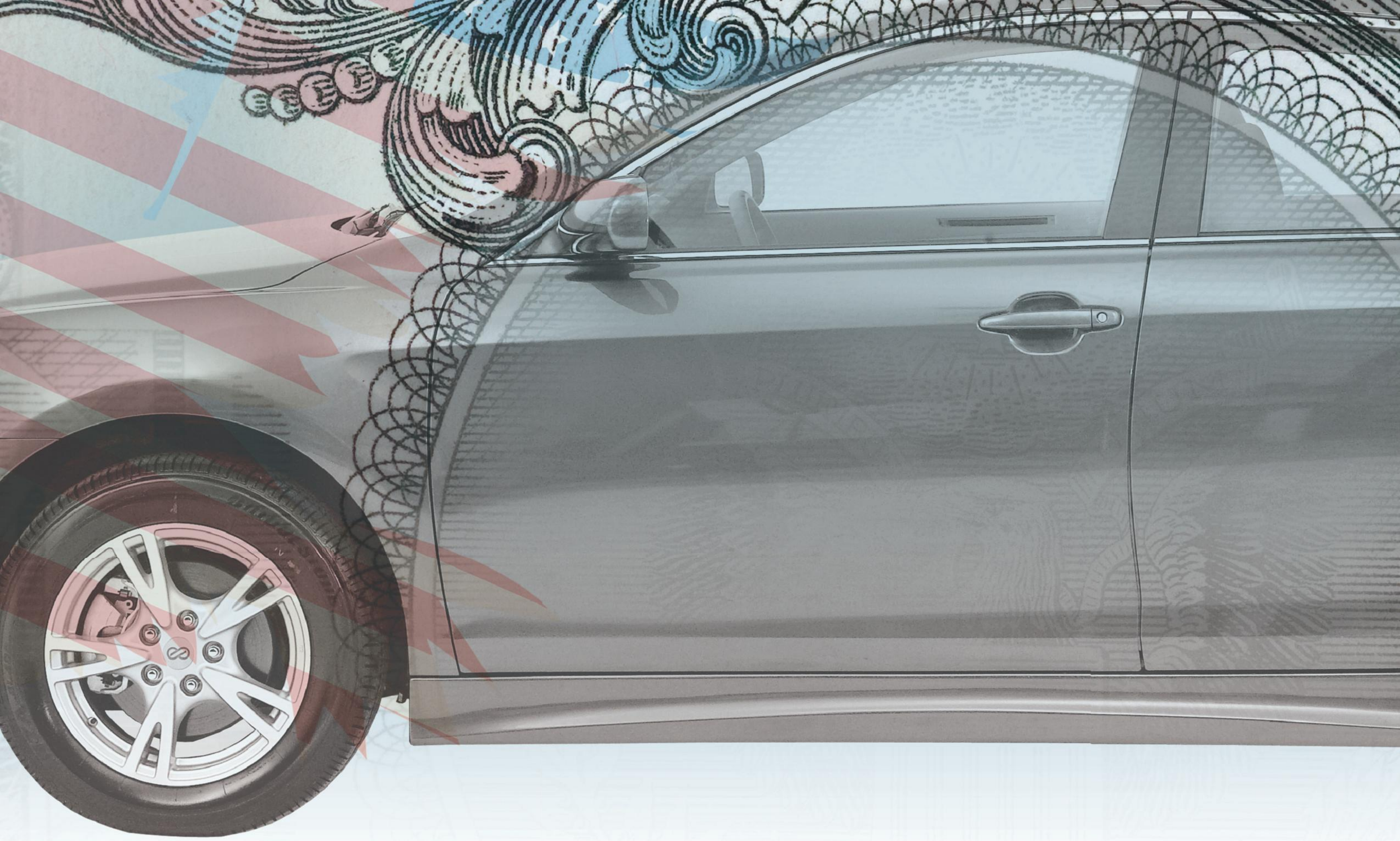
by: Steven Palmieri

As loan securitization on Wall Street had become increasingly popular over the past decade, subprime loans became easier to buy and sell on the secondary capital markets. An effect of this more fluid loan system has been greater government scrutiny and regulation of predatory tactics in the mortgage industry, while the auto industry has seen significantly less regulation.

Unfair, coercive, and deceptive "predatory" trade practices have been illegal since the inception of the Federal Trade Commission Act of 1914. These trade practices have even been referred to as "predatory lending" in the mortgage industry. Taking a brief look at the similarities between the known predatory lending tactics of the mortgage industry and the deceptive sales practices of the automobile industry, we can see why more government regulation may be imminent.

Today, as the government takes control of major U.S. mortgage lending institutions, the auto industry gets closer to being scrutinized for stricter lending regulations. In a financial climate of increasingly stronger consumer awareness, it is important for dealerships to understand that deceptive sales practices in the auto industry could potentially be construed by the Federal Trade Commission as actions so similar to predatory lending that they could be deemed and regulated as such in the future.

Today's market failures intensify the importance of adhering to fundamentally sound business practices as the government responds with unprecedented private business bailouts. The auto and mortgage industries each need a strong banking system and secondary capital market to function effectively. As these two segments become increasingly more illiquid, and the government continues to fund institutional bailouts, it is hard to imagine future government regulation not spreading to the auto industry.



Predatory lending by nature is difficult to define and regulate because the overall context of both the loan and the borrower must be considered when determining if loan attributes may or may not be abusive. By comparing predatory actions of the mortgage industry to "questionable" actions of the auto industry, a dealership can identify potential points of future predatory regulation.

Excessive Fees. Abusive mortgage loans contain fees that are hidden in the mortgage making it difficult for the consumer to know exactly how much is being paid. Retail installment vehicle sales contracts do not have provisions for fees built into the APR; yet, it may happen that a dealer may illegally pass bank acquisition fees on to the consumer by raising the sales price or lowering the trade allowance.

Excessive Interest Rates. A mortgage lender may steer a low-risk consumer toward a higher-rate loan that should be reserved for a higher-risk customer. A dealership that makes large F&I profits by rate reserve alone may be at risk if the profit does not include a good balance of aftermarket products.

Loan Flipping. A mortgage broker who, shortly after the home purchase, refinances the consumer (such as through a "teaser rate") with little financial gain is deemed predatory by nature. A car is generally not refinanced on unfavorable terms, but consumers will continuously trade-up to newer models as the negative equity accumulates to the point where the consumer is "stuck" in the car. This past year has seen auto lenders significantly cutting back on their maximum loan advances. At what point in the future could legislation cap loan advances?

Fraud and Deception. A mortgage broker commits outright fraud by inflating property appraisals and altering loan applications and settlement documents. A finance manager can illegally "power book" a vehicle making the book-value higher than it really is, defrauding the lender and the client. Fraudulent credit applications, inflated consumer income, and aftermarket "product packaging" are all examples of fraudulent and deceptive sales practices.

Prepayment Penalties. Mortgage prepayment penalties are legal, but can be abused by the lender to keep a customer in a loan. Compound interest loans in the auto industry are rare, but prepayment rent charge penalties on leases are common. Could the FTC say that a customer who leases a vehicle at a high loan-to-value and maximum budgeted payment is the victim of predatory lending practices?

California is the first state to proactively prevent predatory lending practices in the auto industry by passing the Car Buyer's Bill of Rights. If the auto industry becomes nationally regulated stemming from today's illiquid mortgage and secondary markets then sales licenses and criminal background checks may become standard practice for the auto industry. Wherever the future of the auto industry may go, a dealership that adheres to strong legal and ethical fundamentals will be safeguarded and should be able to easily grow with future change.

[Steven Palmieri is a managing partner for CMA Financial Corporation which administers the CMA Credit Management Program. spalmieri@cmafincorp.com]