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# Universal Default's Snare on Car Buyers

In economic times like today, there's a high chance your next customer's credit profile is being victimized by universal default. Finance expert explains how universal default works and why understanding the practice can help you get the next deal bought.



By Steven Palmieri

**C**redit card companies have employed universal default as a way to ensure the terms of the credit match the current risk, but does this risk-evaluation tool tell the consumer's full story? Understanding universal default may not only help get your next customer financed, but it will provide a better understanding of the market forces impacting today's credit-challenged customers.

It doesn't take much for an individual to fall into universal default. A one-time financial hardship is all it takes for a consumer to experience the financial avalanche that comes with the universal-default tag. What dealers need to remember is the actual credit worthiness of a customer who falls into universal default may be significantly higher than his or her credit profile indicates. Understanding this can be the difference between rehashing a deal and letting the customer walk.

In a typical car deal, the lender only analyzes the customer's creditworthiness one time before the loan is approved. The lender will not periodically re-evaluate the customer's creditworthiness because an auto loan is a closed-ended contract and the terms of the loan are fixed.

Universal default refers to a specific type of default on an open-ended credit account (i.e., credit card), that has variable loan terms. The credit loan (or credit limit), as well as the credit balance can increase or decrease. Because of this, the customer's creditworthiness must be continuously updated to ensure that the terms of the credit match the current risk. Lenders or creditors often times do a type of inquiry called a "soft pull" of credit, which doesn't show up when a dealer pulls the credit report. The soft pull does not affect the scoring model's calculation, but the results of the soft pull may have potential adverse action on the credit account.

When a customer is considered higher risk or in default on a financial obligation with a lender or creditor, another creditor may place him or her into universal default. With this type of default a creditor has the option of changing the terms of a customer's credit from "normal" to "default," even if the customer's account is current. Section 127 of the Truth in

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Lending Act does not prohibit such adverse actions, so universal default is often disclosed by the lender under the default clause of a credit card application. Customers who do not read the terms of a credit card application before signing up for credit are often unaware universal default exists.

A customer who has several charged up credit cards can also be considered a higher risk even if the minimum monthly payments are paid. FICO's empirical mathematical model calculates 30 percent of a credit score based on the credit profile's debt ratio. A recent increase in the debt ratio of the customer's credit profile can have a negative effect on the score. Under

customer's history with that particular lender. Instead the lender looks at the overall credit profile, debt ratio, and recent credit status changes when approving an auto loan. Universal default simply takes this concept of overall credit profile risk calculation and applies it to the default terms of open-ended credit card accounts.

Dealers who are familiar with the three Cs know that creditors look at character, capacity and collateral when underwriting an auto loan. Using these principles to evaluate credit cards is a good place to start. Character refers to a customer's overall job and payment stability. Capacity refers to a customer's overall financial ability to make continuous

### Falling Out of Favor

Starting in the mid-1990s after banking deregulation, credit card companies began using universal default as part of their default terms. Consumer complaints have since pushed the practice out of favor. And despite some lawmakers changing their tune about the need for universal default, many have stayed away from calling for an all-out ban of the practice.

Take John C. Dugan, the controller for the Office of the Controller of the Currency of the United States. On June 7, 2007, he stated in a speech: "... from a lender's perspective, credit card loans are perhaps the riskiest form of consumer credit ... As a result, credit card accounts require substantial ongoing risk management because a borrower's creditworthiness can deteriorate over time."

*It is important for a dealer to understand there are many forces that can impact a subprime customer. An example would be a subprime customer that makes good income but had a one-time hardship occur. As soon as the customer's financials got behind, he or she may have lost access to much needed credit as a result of universal default.*

However, in a speech he gave on Sept. 27, 2007, Dugan said: "In my view, the fixing [regarding the credit card system] ought to begin with credit card companies adjusting their own behavior, without being forced to do so by new laws or regulations — in recognition of the intensity of consumer complaints ... I think that fixing process has ... begun ... as the majority of large [credit card] issuers ... have eliminated or significantly scaled back such practices as double-cycle billing and true universal default, where the borrower's rate increases as a result of defaults unrelated to his or her repayment history on the card."

There have been many attempts by members of Congress to combat Universal Default. Sen. Jon Tester (D-Mont.) proposed last year the "Universal Default Prohibition Act of 2007" to Congress while Rep. Carolyn Maloney (D-N.Y.) proposed this



the terms of universal default, this drop in score may be enough for the creditor to put the customer in default.

### Understanding Universal Default

In some instances, dealers will advise a subprime customer who wants to buy two cars to do so at the same time, but with separate lenders. Using this tactic avoids future adverse actions that would occur if the creditor qualified the customer for a second loan after the first loan was reported on the credit file. The higher debt ratio would have caused either a future decline or a higher APR in many cases.

Dealers know that lenders do not base an underwriting decision solely on the cus-

tomily payments. Collateral refers to the asset that backs the loan.

Using risk-based pricing in order to determine the initial APR, creditors look at the time-value of money and the perceived future risk of default. A customer who is perceived to be a lower risk should receive a lower APR than a customer who is perceived to be a higher risk. Unlike auto loans, credit cards are revolving accounts, so the balance and credit limit can change frequently. This poses a significantly higher risk to the creditor if the future character or capacity of the customer were to change. Credit cards are unsecured, so there is no collateral for the creditor to hedge the risk against.

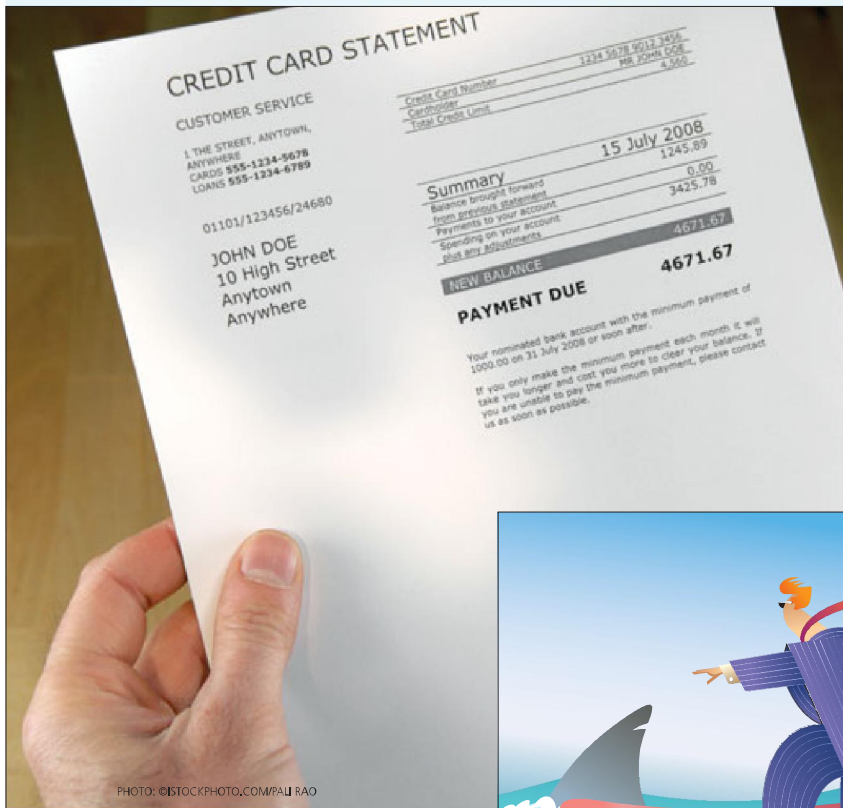


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year the “Credit Cardholders’ Bill of Rights Act of 2008.” Both bills aimed to amend section 127 of the Truth in Lending Act to legally eliminate universal default.

Lenders have also changed their tune about universal default, some going so far as to alter their policies. Citigroup was the first major credit card creditor to eliminate universal default, announcing on March 1, 2007, that it was “...eliminating the industry practice of increasing interest rates for individual cardholders due to their defaults on financial commitments with other parties, sometimes known as ‘universal default.’ Until now Citi has given customers the right to opt out of any such increase. But with this announcement, Citi is going even further, abandoning the practice altogether for all customers.”

Other creditors, such as Bank of America, have also spoken out against universal default.

“Bank of America has never used true universal default,” said Betty Riess, spokesperson for Bank of America Credit Card. “We may re-price accounts based

on a periodic review of credit risk, which takes into account the customer’s performance with us as well as external credit risk indicators. If we decide to make a rate change based on our review of an individual’s account, we will send advance notice to the customer in writing with the option for them to opt out of the rate increase. If the customer opts out, the customer can pay off the remaining balance under the old rates, fees, and terms, provided they agree not to make additional charges on the card. However, the provisions for normal default on the account still apply. The customer’s right to say no and pay back at the original rate is the crucial distinction between risk-based pricing and universal default.”

Bank of America has gone so far as to

create a Website dedicated to educating consumers on how to maintain good credit, as well as how universal default is used by other credit card companies.

Lenders that no longer use universal default are marketing this in a way that may make the customer not want to switch lenders. Chase eliminated universal default in March, and also created its own Website aimed at providing consumers with financial literacy.

It is important for a dealer to understand there are many forces that can impact a subprime customer. An example would be a subprime customer that makes good income but had a one-time hardship occur. As soon as the custom-

er’s financials got behind, he or she may have lost access to much needed credit as a result of universal default. Understanding that those situations occur and being able to ask the customer about situations such as that may provide your dealership with a better chance at rehashing a deal with a lender. The bottom line is that a credit score and an APR are less and less related to each other. It may not matter how many defaulted accounts the customer has, it may be the story behind them that gets the next deal bought. ■

Steven Palmieri is a managing partner of CMA Financial Corporation, which administers the GetACar.com credit management program. He can be reached at [spalmieri@bobit.com](mailto:spalmieri@bobit.com).