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Taken for a Ride

Subprime Lenders, Automobility, and the Working Poor

by Anne Kim

Aside from lack of child care, lack of transportation is perhaps the most common problem facing low-income workers trying to get and keep a job. Despite some notable exceptions, most cities offer less than adequate public transit, with limited schedules, routes, and access to suburbs. In many parts of the country, getting around—or at least getting to work—is impractical, if not impossible, without a car.

Compared to the general population, however, few lower-income families own a car. The most obvious obstacle to car ownership for these families is high prices; last year, the average price of a new car was $25,800.[1] But there is a more insidious barrier to affordability: the unavailability of low-cost credit for working poor families.

Over the past decade, the financial services industry has seen a tremendous surge in the market for high-cost products aimed at poor families who otherwise lack access to mainstream banking services and credit. Auto financing is no exception.

Like check cashers, pawnshops, and other players in the "fringe" financial market, the subprime auto finance industry has grown exponentially over the past decade to serve buyers who cannot get prime-rate credit from mainstream finance companies affiliated with franchised dealers.

Analysts for the Federal Reserve estimate that the subprime auto market has approximately quadrupled over the past decade (from about $15 billion in loans to $65 billion),[2] but some lenders in the industry believe the subprime market is reaching $125 billion a year.[3] However, because there is no source of national data, the exact size and growth of the subprime auto finance industry is difficult to pin down. Even less is known about the industry's practices toward lower-income borrowers, though auto finance is the second largest consumer credit industry in America.

In a modest effort to fill in a few of these blanks, PPI interviewed 40 automobile dealers in the Washington, D.C. area regarding their credit and finance practices. PPI also reviewed financial statements and other documents filed with the Securities and Exchange Commission by a number of publicly traded automobile finance companies that specialize in subprime lending. Our findings from this review, despite its many limitations, point to some troubling conclusions about low-income borrowers' lack of access to affordable auto lending. For example:

- Low-cost mainstream financing options—such as the zero-percent loans heavily advertised on TV—appear to be completely out of reach for many working poor Americans. For example, all of the franchised dealers we interviewed said they would not or could not offer prime-rate financing to a hypothetical worker making $1300 a month—or about $8 an hour—which is slightly more than the average wage earned by former welfare recipients working full time.

- Subprime financing, the only available option for many poor workers, is very expensive. The nation's largest subprime finance companies typically charge interest rates of 18 percent or higher—or about three times the average current interest rates that mainstream borrowers pay—in addition to asking for large down payments. On a five-year, $10,000 loan, this translates into more than $3,600 in additional interest.[4]

- Although subprime finance companies may justify their high rates on the basis of high risks, they are also making big profits. Some publicly traded companies make net yields on their loans that are in excess of 18 percent. And industry analysts for some categories of subprime financiers claim that dealers can make gross profits of 20 percent to 50 percent per sale. This suggests that subprime finance companies can lower their rates significantly and still do quite well. In the meantime, low-income families are paying thousands of dollars in additional interest, or because of these added costs, are unable to afford a car at all.

Lack of competition bears much of the blame for the high prices that lower-income car buyers pay. Mainstream finance companies are leery of doing business in the subprime market and are reluctant to compete with the specialists who now dominate this sector.

But how best to bring down costs? Overregulation is not the answer. Exceedingly restrictive "anti-predatory lending" laws that set ceilings on interest rates or take other proscriptive measures may have the unintended consequence of limiting buyers' options even further.

Congress should instead seek to strengthen competition, not stifle it. Mainstream lenders can and should be encouraged and rewarded for overcoming their reluctance to enter the subprime market. Their presence will broaden the financing options available to low-income borrowers and lower their costs. In the home mortgage industry, for example, increasing competition has significantly narrowed the spread between prime and subprime rates. Furthermore, many low-income borrowers who now rely on check cashers and other nontraditional services may gain valuable exposure to a wider range of mainstream financial services than they currently use. But most importantly, car ownership can be a critical steppingstone to the middle class. Without affordable cars, many working poor families are literally stuck—cut off from the expanded job and housing opportunities that a car can help provide.

Congress can encourage greater competition in the subprime lending industry by taking judicious steps to correct the imbalances that now make the market less than fair to low-income borrowers. For example, it can extend the reach of the Community Reinvestment Act (CRA) to cover finance companies now exempt from the law's requirements to meet the credit needs of low-income borrowers. It can also create a national database to which auto lenders must report their lending practices. This information can help provide lenders with solid information, which is now lacking, about the real risks of doing business with low-income car buyers and can also help to expose and deter lending abuses. Congress can also broaden the availability of financial education so that borrowers can learn to avoid bad deals.

Ultimately, public policy should aim to narrow the gap between subprime and prime interest rates, expand access to prime-rate loans for low-income but potentially creditworthy buyers and, most importantly, bring greater numbers of low-income working families into the financial services mainstream.

The Car Ownership Gap

For the vast majority of Americans, life without a car is unthinkable. Roughly nine out of 10 American households own at least one car,[5] and more than a third have two or more.[6] Nearly nine out of 10 American workers also rely on their cars to commute to work, compared to barely 5 percent of workers who rely on public transit.[7] In fact, the number of cars on the road today far exceeds both the number of licensed drivers and the driving age population.[8]

Personal choice certainly plays a large role in maintaining Americans' dependence on their cars. But suburban sprawl and job growth patterns in recent decades now ensure that for most commuters, cars are absolutely essential. Public transportation systems in most cities today are largely failing to bridge the growing distances between cities and suburbs, and between jobs and affordable housing.[9] For example, a 1998 study of Boston welfare recipients found that while nearly all of the recipients lived within a quarter mile of a bus stop or subway station, less than one third of potential employers were located within a quarter mile of public transit.[10] A similar study in Cleveland found that roughly one-half of the jobs available to inner-city welfare recipients were inaccessible by public transit systems.[11] Nationally, more than one-half of metropolitan area jobs are located in the suburbs, and the overall pace of suburban job growth in the past 10 years has outstripped that of central cities by more than two to one.[12]

Researchers such as Paul Ong have conducted studies showing a strong correlation between car ownership, higher employment rates, and total earnings among welfare beneficiaries.[13] In a recent study of former recipients in Virginia, former recipients who were employed were significantly more likely to have access to a car than those who were not working.[14] The study found, in fact, that a lack of transportation was the third most commonly cited reason for a former recipient's unemployment.[15]

In the absence of adequate public transportation, lack of access to a car can seriously cripple a worker's ability to seek and keep a job. And because physical and social mobility appear to be inextricably linked, it is no coincidence that the sizeable percentage of Americans who do not own cars are also among the nation's most disadvantaged citizens. For example:

- One out of five African-American households lacks a car, compared to one out of 10 households among Hispanics and only 3.3 percent of households among whites.[16]

- About one-third of households earning less than $25,000 a year do not own a car, but among households earning above this amount, the percentage of non-owners is 8.8 percent.[17]

- Among urban households earning less than $25,000, the percentage of African-Americans without a car is nearly twice that of whites with the same income—49 percent for African-Americans versus 26 percent for whites.[18]

- And as for welfare recipients, studies estimate that only 20 percent to 40 percent of recipients have access to a car.[19]

Evidence suggests that inequality in car ownership rates is further linked to inequalities in the amount of time spent commuting and in the proportion of household income spent on transportation.

For example, working African-Americans and Latinos have longer average commutes than whites, in part because of their heavier reliance on public transit. About 14 percent of African-Americans rely on public transit to commute to work—nearly five times the percentage of whites and three times the overall rate. Among Latinos, the percentage of transit users is about 9.5 percent.[20] As a consequence, according to one government study, the average commuting time for African-American workers is 23.66 minutes and for Latino workers 22 minutes, compared to 20.23 minutes for whites.[21]

African-Americans and Latinos also spend a larger proportion of their income on transportation expenses than whites, although the dollar amount of their expenditures is smaller. In 1995, African-Americans and Hispanics spent an average of 17.5 percent and 18.8 percent of their annual household incomes on transportation, while for white non-Hispanics, the annual average expenditure was 16.1 percent of household income.[22]

Car ownership, by itself, is obviously no panacea for correcting economic inequalities or for helping workers at the bottom of the ladder climb higher. But eliminating barriers to car ownership can help rectify some of the disparities in the quality of life and opportunities available to those who own cars and those who do not.

Between a Rock and a Subprime Lender: Financing Options for the Working Poor

Because of the American appetite for cars, auto manufacturing and financing are among the nation's largest industries; in 2001, new car sales alone totaled approximately $690 billion.[23] Given the vast number of cars on American roads today, it seems unlikely that cars are outside anyone's financial reach. And indeed, the American dependence on cars stems in large part from their relative availability and affordability—at least for the middle class.[24]

Although average car prices are at all-time highs—$25,800 for new cars and $13,900 for used[25]—rising median family incomes coupled with historically low interest rates have made car buying relatively cheap over the last few years. In 2001, the average interest rate charged by finance companies for new car loans was a mere 5.7 percent, while the average bank interest rate for new car loans was 8.5 percent.[26] And, as anyone with a television knows, dealerships relentlessly advertise even better deals—zero down payment, zero interest, big rebates, etc.—for "qualified" buyers.

The auto industry's generous attitudes toward credit and finance do not, however, extend to lower-income buyers, especially those without established credit. These buyers are virtually shut out of the mainstream auto finance market because of their low income, lack of credit and/or past credit problems. Mainstream companies also often refuse to finance older vehicles, which are often the only cars that low-income buyers can afford. For low-income buyers, often the only option is the high-cost subprime auto financing industry. Although these dealers may promise "No Credit, No Problem!" the price that consumers pay for those promises can be exorbitant.

The Survey

Unlike other realms of consumer finance, auto lending is still a highly personalized industry, one that is based on direct contact between dealer and customer and on face-to-face negotiation. Getting a "good" deal seems to depend as much on the knowledge and bargaining skills of the consumer as on objective parameters of "creditworthiness." The relative lack of hard-and-fast financing standards—as well as the lack of a central, nationwide source of information on the auto finance industry—complicates the process of surveying the financing options available to low-income buyers.

PPI's research into the subprime auto lending industry is based principally on two methods. First, we conducted an extensive review of financial statements, annual reports, and other documents filed with the Securities and Exchange Commission by publicly traded finance companies that specialize in subprime auto lending, as well as publicly available industry and government data. Interviews were also conducted with 40 car dealers in and around the Washington, D.C. area. Sixteen of the dealers contacted by PPI were franchised new car dealers affiliated with major auto manufacturers, and the remainder consisted of independent used-car dealerships, some of which were little more than storefronts offering half a dozen cars at a time. Dealers were generally told that the purpose of the interviews was to collect information on the financing options available to low-income workers without established credit. Perhaps surprisingly, dealers freely discussed their business practices, although very few of the independent dealerships would disclose the names of the finance companies with which they did business.

Because there is no single accepted definition of subprime financing, the term is used in this paper to indicate all forms of non-conventional auto financing, that is, financing other than the loans extended by mainstream or captive finance companies to buyers with prime rate credit. PPI's analysis categorizes subprime auto financing into three overlapping categories: (1) higher-interest-rate loans from finance companies or banks; (2) so-called "buy here/pay here" financing by the dealer itself (rather than through a finance company) and (3) "cash and carry" programs which arguably involve no financing at all. Each of these tiers of financing is progressively more expensive in terms of down payment requirements, interest rates, and other provisions.

Availability of mainstream financing

With the exception of buy here/pay here dealers discussed below, most dealers do not originate and service the loans they make to their buyers. Instead, they act as conduits for a bank or a finance company that actually arranges the loan, or they may originate a loan and sell it at a discount to a finance company that will take over servicing and collections. Although many dealers work with a variety of lenders, franchised dealers work primarily with a "captive" finance company (for example, General Motors Acceptance Corporation). In all cases, financing extended by or through a dealer must satisfy the underwriting standards of the bank or finance company originating or purchasing the loan.

In the PPI interviews, the car dealers were asked whether, and on what terms, financing would be available to a low-wage worker earning approximately $1,300 a month with limited credit history. This income level is equivalent to a full-time hourly wage of $8.12, which is slightly more than the average median wage of working welfare leavers.

None of the 16 mainstream, franchised dealers interviewed said that the banks and finance companies they work with would offer prime-rate financing to such a buyer, although some said higher-rate financing might be available if the buyer also had an established history of good credit. Fourteen of these 16 dealers, however, said they would not offer any sort of financing at all. Most of the dealerships would not disclose whether there was a minimum income requirement for buyers seeking financing, but of those that did, two dealerships said they required a gross income of at least $1,500 a month (which amounts to $18,000 annually), and one dealer required $2,500 (or $30,000 a year), regardless of a potential borrower's credit.

Subprime financing options

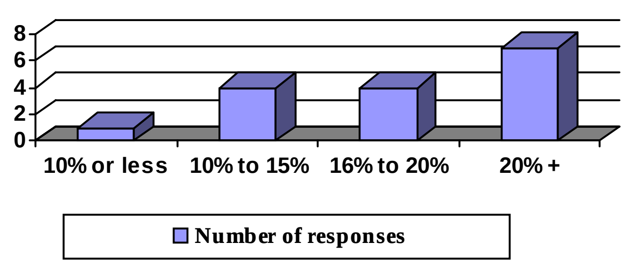
Among dealers that work with subprime lenders, however, financing options for low-income workers were plentiful, albeit substantially more expensive.

- ***Subprime finance company loans***

Because of the lack of centralized information about the practices of finance companies, determining the average interest rates charged by subprime lenders is an inexact science. Of the dealerships interviewed by PPI, only 16 volunteered specific information about the range of interest rates at which they offered subprime financing. (A number of dealerships said they offered "zero-percent" financing, but these dealerships are in a special category of buy here/pay here dealers that are discussed below.) The high end of these ranges varied from 9 percent to 24 percent, and eight dealers said their highest-rate loans were above 20 percent.

While illustrative, this information does not, however, answer the question of what a typical subprime borrower pays. A better picture of the average rates paid by subprime borrowers can be found through analysis of the public documents filed by subprime finance companies with the Securities and Exchange Commission. Most major, publicly traded finance companies raise money for their lending activities through securitization—that is,

Graph 1: Maximum interest rates charged by subprime auto lenders interviewed in Washington, D.C. area



by pooling the loans they purchase and selling debt securities that are backed by those loans. AmeriCredit Corporation, for example, one of the nation's largest subprime auto finance companies, has securitized approximately $14.9 billion in loans since 1994.[27]

The documents filed by subprime finance companies in connection with the securitization of their loans provide such information as the average size of the loans securitized, their average term, and their weighted average annual percentage interest rate (APR). In general, interest rates on subprime finance company car loans are about as high as those that are usually charged on credit cards—more than double and often triple the interest on that of prime-rate new car loans. Table 1 illustrates some further examples.

While this chart shows average APRs for large groups of loans, interest rates for individual loans can often be much higher. For example, the upper end of the interest rates on the loans securitized by Capital One ranges from about 25 percent to 30 percent.[28]

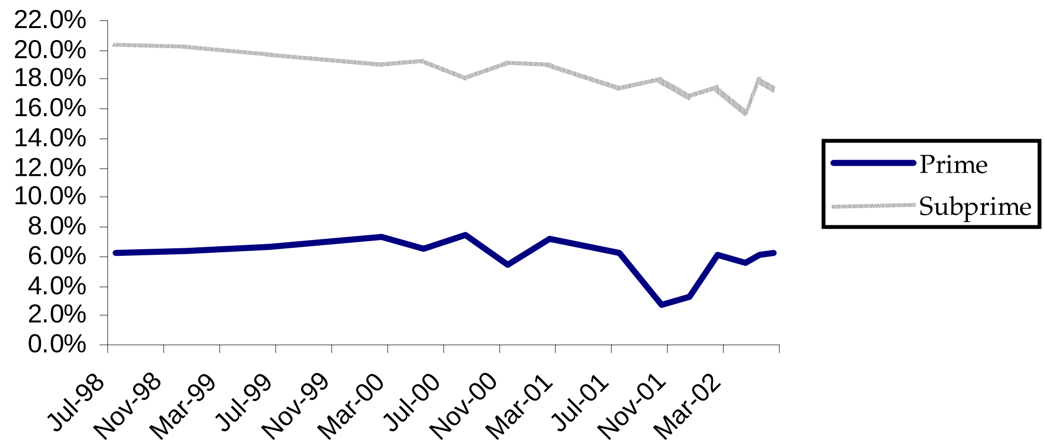
To illustrate the disparity between prime and subprime interest rates, Graph 2 compares the average APRs listed in Table 1 with the his-

Table 1
Sample Average Interest Rates Charged by Public Subprime Finance Companies[29]

Finance Company	Amount of Securities Issued	Date of Securitization	Weighted Average APR of Pooled Loans
AmeriCredit	$1.3 billion	February 2000	18.72%
AmeriCredit	$1.2 billion	May 2000	19.28%
AmeriCredit	$500 million	November 2000	19.21%
AmeriCredit	$1.4 billion	February 2001	19.06%
AmeriCredit	$1.6 billion	February 2002	17.57%
AmeriCredit	$1.2 billion	June 2002	17.31%
Capital One	$850 million	July 2001	17.37%
Capital One	$1.3 billion*	December 2001	16.59%
Capital One	$1.3 billion*	April 2002	15.49%
Consumer Portfolio Services, Inc.	$253 million*	December 1998	20.03%
Consumer Portfolio Services, Inc.	$172 million*	July 1998	20.41%
Household Finance Corporation	$966 million*	June 1999	19.05%
Household Finance Corporation	$662 million	August 2000	18.07%
Household Finance Corporation	$660 million	February 2001	18.36%
Household Finance Corporation	$1.1 billion	October 2001	17.70%
Household Finance Corporation	$1.1 billion	May 2002	17.80%

*Principal balance of loans securitized.

Graph 2: Comparison of prime vs. subprime interest rates



Source: Federal Reserve Statistical Releases, Consumer Credit, and Table 1 of this paper. Loans are generally "seasoned"—that is, they are one or two months old—by the time they are securitized. The average "prime" rates provided for comparison in this column are the prevailing rates at in the month of securitization, not in the month of origination. Because of the short seasoning period on these loans, the difference between prevailing interest rates at the date of origination versus the date of securitization is relatively small.

toric average finance company rate for new car loans as reported by the Federal Reserve at approximately the date of securitization.

Buy here/pay here

As costly as they are, finance company loans may nonetheless be available only to a fraction of low-income families. While subprime finance companies purport broadly to serve borrowers "who do not qualify for conventional motor vehicle financing as a result of, among other things, a lack of or adverse credit history, low income levels and/or the inability to provide adequate down payments,"[30] many low-income buyers still do not qualify for a finance company loan.[31] For example, Nicholas Financial, Inc.'s typical borrower is "30 years old [and] has a monthly gross income of $1,700,"[32] and Consumer Portfolio Services' average customers are "approximately 37 years of age, with approximately $35,693 in average annual household income and an average of 4.5 years' history with his or her current employer."[33] Neither of these profiles fits that of the most vulnerable members of the working poor—namely, those in the midst of the fragile transition from welfare to work.

These poorer customers instead rely on storefront independent used car dealers, many of whom engage in a practice known as buy here/pay here. Rather than rely on finance companies or banks to finance loans to their borrowers, buy here/pay here dealers offer the initial financing to their customers themselves (although they may later sell their receivables to a finance company in order to raise capital).

This arrangement can be attractive to low-income borrowers for a number of reasons. First of all, the amount that is financed is relatively small, and therefore more likely to fit the limited budget of a low-income worker. According to the National Association of Buy Here/Pay Here Dealers, the average retail price of cars sold at these dealerships is less than $4,000, far below the average used car price of $13,900.[34] Second, borrowers can bring installment payments directly to the dealership, rather than mailing a check to the bank. For borrowers without checking accounts—of which there are many—this arrangement can be very convenient.

Thirdly, no credit is no problem. Of the 40 Washington, D.C. dealers interviewed, 18 offered buy here/pay here financing. In making credit decisions, some dealers said they rely on factors such as proof of employment or time spent at current residence, but the majority of dealers said even those details are unnecessary. The laxity of the credit check is made up for by the terms of the sale: Eight of the 18 buy here/pay here dealers interviewed required a down payment equal to 50 percent of the purchase price, and two of the dealers required a 75 percent deposit. The remainder required a down payment of one-fourth to one-third of the purchase price. The balance was typically due in bi-weekly (or even weekly) installments, and the term of the financing was generally no longer than one year. (Because the cars sold by these dealers are likely to be fairly old, a very short-term loan makes the most sense; borrowers are less likely to make payments on a car that doesn't run.) These transactions in fact have less in common with traditional auto financing than with other non-traditional credit arrangements, such as renting-to-own.

Cash and carry

A minority of dealers interviewed offer no "financing" at all but demand 100 percent of the purchase price up front, paid either in cash or by credit card. These dealers tend to be very small operations that sell very inexpensive cars. Among the three dealers interviewed in Washington that fit this category, the cars sold were priced as low as $200 to $650. The high end of sales prices ranged from $2,500 to $15,000. As with buy here/pay here dealers, the chief disadvantage of relying on a cash and carry dealer is the lack future mainstream financing opportunities.

The price of subprime financing

Both the cumulative and day-to-day impact of a subprime loan on a lower-income worker's budget can be substantial. Table 1 shows a series of hypothetical calculations based on the data in Table 1 and Graph 2 for a 60-month, $10,000 loan. The table shows the difference in interest payable at subprime versus prime rates.

But high interest rates are not the only source of added costs for subprime borrowers. To add insult to injury, the cars that are financed by these buyers are typically older, with higher mileages and perhaps no warranties. The cars financed by Consumer Portfolio Services, for example, are three years old on average (although the company will not finance cars that are more than seven years old or have mileages over 85,000).[35] And the older the car, the higher the finance charge.[36] Car repairs can add significantly to the cost of owning a car.

Graph 3: Down payment requirements, independent buy here/pay here and cash and carry dealers in Washington, D.C. area

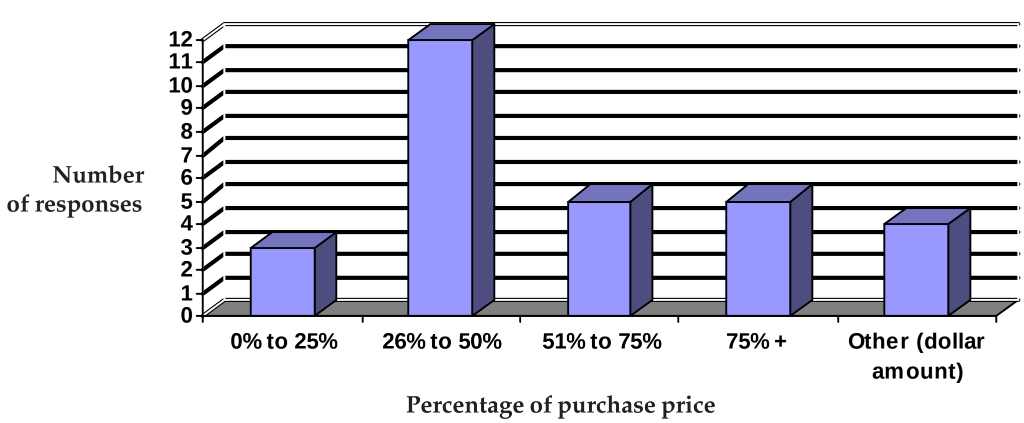


Table 2
Impact of Subprime Interest Rates
(five-year loan with principal balance of $10,000)

	APR	Monthly payment (60 months)*	Total payments	Total interest	Additional interest paid
AmeriCredit (June 2002)	17.31%	$250.30	$15,000.00	$5,000.00	**$3,300.00**
Prime rate	6.29%	$195.00	$11700.00	$1,700.00	
Household (June 1999)	19.05%	$260.09	$15,600.00	$5,600.00	**$3,960.00**
Prime rate	6.15%	$194.00	$11,640.00	$1,640.00	
Capital One (April 2002)	15.49%	$240.00	$14,400.00	$4,400.00	**$2,940.00**
Prime rate	5.51%	$191.00	$11,460.00	$1,460.00	
CPS (Dec. 1998)	20.03%	$265.00	$15,900.00	$5,900.00	**$4,200.00**
Prime rate	6.43%	$195.00	$11,700.00	$1,700.00	

*All calculations were derived using a Web-based loan calculator. All amounts are rounded to the nearest dollar.

Industry practices, moreover, are geared toward the goal of squeezing as much cash as possible out of consumers. Borrowers obtaining subprime finance company loans are also often required to put down significant down payments. For example, the average down payment on loans financed by Consumer Portfolio Services, Inc. in fiscal 2000 was 13.2 percent of the purchase price.[37] Nicholas Financial, Inc., a smaller subprime finance company, requires a down payment of between 5 percent and 20 percent of the purchase price, and Household Finance Corporation typically requires a minimum of 10 percent or $1,000 (although some borrowers with better credit do not have to make a down payment).[38]

Many dealers also encourage borrowers to obtain additional financing for "add-on" options, such as credit life insurance, a product condemned by consumer groups as "the nation's worst insurance rip-off."[39] For example, approximately 20 percent of Nicholas Financial, Inc.'s borrowers in fiscal 2001 opted to finance the cost of add-on products, such as "a roadside assistance plan, extended warranty protection, credit life insurance, credit accident and health insurance and credit property insurance."[40] Given that the average effective interest rate of the company's loans is 24 percent,[41] the effect of financing even an additional $1,000 in add-on products can be substantial—in fact, it would amount to an additional $28.76 a month or $1,725.60 over the life of a five-year loan. Because of these add-on options, many borrowers may also end up financing an amount that exceeds the value of the car—a practice that some finance companies may tacitly encourage. Consumer Portfolio Services, for example, permits its participating dealers to finance up to 115 percent of the wholesale book value of a used car and up to 110 percent of the manufacturer's invoice on new cars.[42]

In addition, some finance companies structure their loan purchase programs in such a way as to encourage dealers to negotiate the highest interest rates possible or to add on extra products and costs. For example, Consumer Portfolio Services purchases loans at a price equal to the total amount financed under a contract, minus an "acquisition fee" that ranges from zero to about $1,600.[43] Obviously, the higher the amount financed, the larger the profit after acquisition fees are deducted. Similarly, Nicholas Financial, Inc. purchases contracts from its dealers for a processing fee of $75, plus a 1 percent to 15 percent discount from the original principal amount being financed.[44] By bumping up finance charges by several percentage points, dealers can neatly transfer these costs to borrowers.

Finally, some dealers appear to engage in less than scrupulous practices with their customers. For example, all of the buy here/pay here dealers interviewed by PPI, except for two, offered what they called "zero-percent" financing. But zero-percent financing in the buy here/pay here context is vastly different from what is offered by the "Big Three" automakers. Several of the dealers contacted said they did not charge interest because they believed that they would be exempt from regulation. (One dealer said he charged a 10 percent "service fee" in lieu of interest.) It is not irrational to assume that these dealers probably do not adhere scrupulously to fair lending and consumer protection laws.

But most of the buy here/pay here dealers do not charge interest because they do not need to do so in order to make a profit. Although dealers were understandably reluctant to say so, several of those interviewed acknowledged that the down payment paid on a car was enough in most cases to cover the dealer's costs. In other words, the other 50 percent to 75 percent of the purchase price is pure profit. And if a 50 percent balance on the "purchase price" is essentially financing in disguise, customers are paying the equivalent of 100 percent interest.[45]

There are other serious disadvantages to subprime financing, especially buy here/pay here financing, beyond its monthly impact on the pocketbook. Large down payment requirements can mean that buyers spend a long time accruing a sufficient amount of cash—cash that may otherwise be needed for day-to-day necessities. It could also mean that lower-income buyers are either unable to afford a car at all or are forced to purchase a lower-priced and often lower-quality car. (For example, a 5 percent down payment requirement can put a buyer into a late-model $10,000 car for only $500. But if the required down payment is 50 percent, that same $500 can only be put toward a $1,000 potential lemon.)

Higher-cost debt also partly accounts for the disproportionately high debt burden under which many low-income families now struggle. According to the Federal Reserve, about one out of three families with annual incomes under $10,000, and one out of five families with annual incomes under $25,000, have debt payments totaling more than 40 percent of their income. By contrast, less than 6 percent of families with incomes between $50,000 and $100,000 have debt-to-income ratios that high.[46]

In addition, high monthly payments could have the perverse effect of trapping a family in the subprime market. For families living paycheck to paycheck, even a minor financial setback—such as an illness costing a few days' pay—could cause a family to fall behind on a loan. As a consequence, this family may never establish the good credit history necessary to move up the ladder into prime-rate financing.

Perhaps most damaging, however, is that consumers cannot rely on subprime dealers, and particularly buy here/pay here dealers, to serve as a bridge into obtaining mainstream credit. According to some consumer groups, buy here/pay here dealers commonly do not report their customers' credit to major credit bureaus, or if they do report credit, they only report delinquencies.[47] Thus, customers with spotless payment records are nonetheless not building the credit history they need to qualify for lower-rate loans and are likely to remain trapped in the subprime market.

Profit versus risk

Subprime finance companies argue that they provide a valuable service in offering credit to borrowers whom mainstream lenders would otherwise turn away. And indeed, over the past decade, subprime lenders have helped open the home mortgage market to low-income and minority homebuyers, which in turn has helped push minority homeownership rates to record levels.[48] Subprime lenders also argue that the high prices they charge are justified by the risks they are taking on. Lower-income borrowers are, in fact, more likely to default on their obligations and obviously have fewer assets for a lender to attach as collateral. But are subprime lending costs *too* high? Some risks certainly justify a premium, but some evidence suggests that the prices charged by some subprime lenders are out of proportion to the risks they are taking on. The big profits made by some financiers—and the stunning growth of the industry in just the past decade—belie claims that subprime financing is a low-profit, high-risk business for those who dare to participate.

For example, buy here/pay here financing can be immensely lucrative for dealers. Among the more successful buy here/pay here franchises is the Ugly Duckling Corporation, which operates 76 dealerships nationwide. In fiscal 2001, its average gross margin per sale was $3,906, or 42.9 percent.[49] More generally, one industry source claims that a buy here/pay here dealer that sells cars for an average price of about $6,500 can make average gross profits per car of $3,400—or 52 percent of the purchase price. On average, according to this study, nearly 23 percent of gross revenues are net profit.[50] The National Association of Buy Here/Pay Here Dealers, however, provides a slightly lower estimate of gross profits at $1,800 and $2,000 per car.[51] (This trade group, however, also believes the average sales price to be under $4,000.)

Finance companies, on the other hand, make profits by lending money at a higher rate of interest than at which they borrow it (including by securitization). According to the annual reports of Nicholas Financial, Inc., for example, the company borrowed funds at an average rate of 7.66 percent in fiscal year 2002, 8.15 percent in 2001, and 8.03 percent in 2000.[52] The interest charged on the company's loans, however, was sufficient to give the company a gross portfolio yield of 23.53 percent in fiscal year 2002 (on approximately $84.4 million in loans), 23.79 percent in 2001 (on about $73.1 million in loans), and 24.64 percent in 2000 (on about $55 million in loans). Net yields in those years were almost as healthy—at 18.91 percent in fiscal year 2002, 18.64 percent in 2001, and 19.61 percent in 2000.

The spectacular growth in recent years of other large, publicly traded companies that specialize in subprime auto financing is further evidence of the industry's potential for profitability, despite the risks involved.

Household Finance Corporation, for example, one of the nation's largest subprime finance companies, serviced nearly $6.4 billion in auto loan receivables in fiscal year 2001, more than double the amount of receivables it serviced in 1999.[53] As of December 31, 2000, Capital One Auto Finance had tripled the amount of its outstanding loans since 1998.[54] Since 1996, AmeriCredit has increased its earnings by 41 percent per year,[55] while more

Table 3
Profitability of Subprime Loans, Nicholas Financial

	Principal balance of loans	Average cost of borrowed funds	Gross portfolio yield [a]	Net interest spread [b]
2002	$84.4 million	7.66%	23.53%	15.87%
2001	$73.1 million	8.15%	23.79%	15.64%
2000	$55.0 million	8.03%	24.64%	16.61%

[a] Represents interest income as a percentage of average finance receivables.
[b] Represents the gross portfolio yield less the average cost of borrowed funds.

than doubling the dollar volume of loans it purchases from its dealers, who now number 16,280 nationwide.[56] From 1994 to 2001, the company also securitized nearly $15 billion in contracts.[57]

New underwriting technologies have also made it possible for finance companies to maintain big profits by keeping their losses and delinquencies relatively low. Not all low-income consumers are poor credit risks, and in fact, many are just as likely to pay off a debt as a person with higher income or assets. Many companies rely on computerized underwriting (i.e., "automated underwriting") to sort out these good risks from the bad ones. Ironically, automated underwriting is also credited with opening up mortgage markets to minority and low-income homebuyers. Automated underwriting broadens the array of variables taken into consideration by a lender and removes much of the element of human discretion, thereby reducing the possibility of racial discrimination. Subprime lenders, however, use automated underwriting to reduce their risks but not their prices.

As a consequence, delinquency rates among subprime finance companies are not as high as some might expect. Nicholas Financial, Inc., for example, reported that only 2.32 percent of the outstanding balance of its loans were delinquent in fiscal year 2002, 1.90 percent were delinquent in 2001, and 2.31 percent in 2000.[58] By contrast, the percentage of delinquent accounts at General Motors Acceptance Corporation (past due over 30 days) was 2.4 percent in both 2001 and 2000.[59]

Similarly, at Household, delinquency ratios during fiscal 2001 varied from a low of 1.77 percent in the first quarter to 2.89 percent in the fourth.[60] Consumer Portfolio Services and Capital One had somewhat larger default rates; for Capital One, the percentage of serviced loans delinquent for 30 days or more was 7.69 percent in fiscal 2000,[61] and delinquencies totaled 6.9 percent of Consumer Portfolio Services' portfolio in fiscal 2001.[62] Net losses, of course, can be significantly lower.

This analysis cannot begin to judge what prices are "acceptable" for various risks, but greater competition in the subprime industry could arguably lower rates significantly for consumers. Subprime finance companies are fully aware that they are not operating in a fully competitive market. As Nicholas Financial, Inc.'s annual report puts it:

> "Although prime borrowers represent a large segment of the automobile financing market, there are many potential purchasers of automobiles who do not qualify as prime borrowers [and] are generally unable to obtain credit from traditional sources of automobile financing. The Company believes that, because these potential purchasers represent a substantial market, there is a demand by automobile dealers with respect to financing for non-prime borrowers that has not been effectively served by traditional automobile financing sources."[63]

Broadening Access to Mainstream Credit

Since the 1996 welfare reform, a growing number of analysts and policymakers have begun to realize the importance of adequate transportation, including affordable access to cars, in ensuring a long-lasting transition from welfare to work. Over the past several years, there have been several innovative efforts to expand car ownership by increasing the financial resources available to low-income buyers. Matched savings programs, purchase price subsidies, and down payment assistance are examples of these initiatives.[64]

Equally important, however, is eliminating the barriers to affordability within the auto finance market itself. It is important to keep in mind that lack of income does not automatically translate into lack of creditworthiness. There are many responsible, bill-paying, lower-income workers who may never graduate into the mainstream financial services market, simply because they are overlooked by mainstream financial service providers or are never provided the opportunity to prove their creditworthiness.

Competition, not regulation, is the best way to bring down prices in the subprime auto financing market. Encouraging mainstream finance companies to enter the subprime market will broaden the variety of financing options available to car buyers and force companies to compete for their customers by lowering prices and fees. In part because of a shakeout among subprime lenders in the late 1990s, which heightened perceptions of the market's risks, and in part because of the subprime industry's sometimes less-than-savory reputation, many mainstream lenders have been cautious about entering the subprime finance world.[65] Consequently, the industry's dominant players are subprime specialists, such as Household and AmeriCredit, or specialized subsidiaries of mainstream companies, such as Nuvell Credit Corporation, a newly formed subprime subsidiary of GM.

But the growth and profitability of companies such as Household, AmeriCredit, and Nicholas should be proof enough that subprime consumers can be a worthwhile market for mainstream lenders to tap. And the ready availability of "automated underwriting" and other sophisticated techniques can help lenders better manage the risks of this new market. Although the market may dictate that lower-income borrowers will always pay slightly more for financial products than wealthier consumers, the current disparities in pricing can certainly be narrowed.

"Mainstreaming" the subprime market will ultimately benefit both lenders and borrowers. Lenders will have access to a new and growing customer base, especially as welfare reform brings more new workers into the labor force. Borrowers will pay less for a broader range of products.

Mainstreaming will also help reverse the growing split in the financial services industry between the products available to the middle-class and the high-cost services targeted at the poor. While middle-class consumers and borrowers enjoy broad access to wealth-building tools such as savings accounts, certificates of deposits, and IRAs, the services available to low-income consumers, such as subprime auto financing, check cashing, and other "fringe" financial services, are more likely to strip wealth than to create it. The same lack of credit history that compels some low-income buyers to rely on subprime and nontraditional financing services likely stems from a more generalized lack of access to mainstream banking services, such as a checking account. Without a bank account, savings, and other basic financial tools, it is unlikely that a low-income worker can ever secure a foothold in the middle class. Building one broad market for financial services can erase this burgeoning inequality in financial opportunity and access while making financial products available at lower prices to everyone.

The challenge for policymakers is how best to encourage greater competition in the subprime auto finance industry without over-regulating or imposing other burdens that have the unintended effect of stifling competition yet further. PPI suggests the following:

- ***Promote equal access to car ownership as a policy priority.*** Many policymakers have begun to look toward "asset-building" as a long-term strategy for helping low-income families climb the economic ladder. With a few exceptions, policymakers have, however, tended to discount the potential importance of car ownership and have instead focused on other aspects of asset-building, such as homeownership or savings.

While these priorities should maintain their paramount importance, car ownership also deserves greater attention, especially in the absence of major initiatives to upgrade the nation's public transit systems. In many cases, owning a car can have greater positive impact on a family's immediate economic prospects than owning a home. Unlike houses, which are long-term investments to build wealth, cars are income-producing assets in the short term; they can make it possible for poor workers to commute to higher-paying jobs, for example, or to move to an area with cheaper housing and more opportunities to save money.

Any new policy initiative to promote car ownership should follow the example set by the homeownership promotion efforts of the 1990s, which have proven widely successful. During the 1990s, the percentage of American homeowners—including low-income and minority homeowners—rose to record highs. In 2001, the overall homeownership rate was 67.8 percent, and among African-Americans and Hispanics, homeownership rates were 48.4 percent and 46.4 percent respectively.[66] This remarkable achievement was due in part to a broad-based policy initiative by the Clinton administration to boost homeownership rates, especially among minority and low-income families. With the encouragement of the administration, Freddie Mac, Fannie Mae, and other industry players created a variety of new financial products aimed at low-income borrowers, many of which are adaptable to the auto finance industry. These innovations included lowering down-payment requirements, considering alternative sources of income when making lending decisions, and facilitating mortgage applications in Spanish or other languages. Some programs also rewarded low-income borrowers with good payment records by "graduating" them from higher-cost loans into less-expensive ones.[67]

By setting a strong policy agenda committed to making cars more affordable to working poor families who need them, policymakers and Congress can impress upon the auto finance industry the critical importance of broadening access to affordable credit.

- ***Expand the reach of the Community Reinvestment Act (CRA).*** In the 25 years of its existence, the CRA has had a major impact on increasing the availability of credit, especially home mortgage credit, to underserved, low-income and minority communities.[68] Under the CRA, financial institutions subject to its requirements are periodically graded on the adequacy of their lending activities to the communities they serve, including lower-income and minority consumers. Depending on the size of the institution, examiners analyze such factors as the extent of community development activities and the amount, type, and distribution of loans. All grades are made public, and regulators can punish poorly performing institutions by refusing to approve applications for merger. Because of widespread consolidation in the banking industry in the last decade, CRA scores have occasionally had a decisive impact on an institution's future.

CRA's reach, however, is limited to depository institutions, and the finance companies that engage in the bulk of auto lending (including subprime lending) are exempt from its oversight. In fact, over the years, the reach of the CRA has become more limited. According to the Federal Reserve, finance companies held roughly $1 trillion in assets in mid-2000—about twice the amount of total assets held by credit unions and about the same as that of thrifts.[69]

A growing number of policymakers have begun to call for CRA's modernization, including the expansion of its scope. If Congress takes up this challenge, it should (1) include finance companies among the institutions that are answerable to CRA's requirements, (2) broaden CRA's focus to encompass auto financing (since current exam criteria are principally concerned with home mortgage loans), and (3) include new measures to gauge the cost and *quality* of the credit extended to lower-income borrowers. As it did with the home mortgage industry, the CRA may prove an effective lever in encouraging mainstream finance companies to offer more and lower-priced auto financing to low-income buyers. Imposing at least the same CRA standards on finance companies as on banks will both strengthen the role of the CRA and continue to help ensure that all consumers have fair access to credit.

- ***Improve data collection on the subprime auto lending industry.*** Automobile financing makes up a significant portion of the more than $1.6 trillion dollar consumer credit industry,[70] of which finance companies are the principal providers. According to the Federal Reserve, finance companies financed almost $338 billion in car loans in 2000.[71] Despite its size, relatively little information is available about the industry's practices. Unlike home mortgage lenders, for example, who are subject to disclosure requirements on their lending practices under the Home Mortgage Disclosure Act (HMDA),[72] there are no reporting requirements on automobile finance companies. As a consequence, there is no definitive, national source of data on whether these companies are engaged in fair lending or whether their practices are biased against consumers of particular racial or economic groups.

Some evidence tends to indicate that finance company borrowers are more disadvantaged—and perhaps more vulnerable—than those who borrow from banks, which only emphasizes the need for oversight. According to some studies, finance company customers "are generally younger, less likely to be white and more financially insecure than their bank-borrowing counterparts."[73] It is also possible that many subprime borrowers could have qualified for loans in the prime market. Several studies in the home mortgage lending context have found that a significant percent of subprime borrowers are actually eligible for prime-rate loans and have been relegated undeservedly into the subprime market.[74] It is quite likely that a similar situation exists in the subprime auto finance industry, which disclosure requirements can help bring to light. Disclosure requirements may also make it easier to quantify the actual risks of lending to low-income borrowers. Part of the current distortions in the market stem from lack of systematized knowledge about repayment and delinquency rates among borrowers at these income levels.

Currently, the only way to obtain detailed information on finance company practices is to sue, which a number of plaintiffs have done. Class-action suits now pending in several states are charging General Motors Acceptance Corporation, Nissan Motor Acceptance, and other major auto companies with systematically discriminating against minority buyers by charging them higher finance rates.[75]

The specific practice being challenged in these suits is the "dealer markup," under which dealers are encouraged to charge an interest rate that is several points higher than the company's established interest rate for a customer with a particular credit history and income level. For example, if a financing company is willing to extend a loan at 6.5 percent, the dealer markup may mean that the consumer ultimately pays 8 percent or 9 percent on the loan. Dealers are under no legal obligation to disclose the amount of the markup, and the lawsuits claim, in part, that markups are generally larger for African-Americans than they are for whites. Expert analyses of loan records obtained in litigation allege that Nissan charges nearly three-fourths of African-American buyers a dealer markup, versus less than half of whites, and that on average, African-Americans are charged a dealer markup that is $500 higher than the markup charged to whites.[76]

Regardless of the merit of these lawsuits, a national reporting requirement can impose a powerful incentive on auto finance companies to play it straight. Putting finance company practices into full view will prevent companies from concealing potentially unfair practices and ease the task of monitoring the companies' behavior. Although a reporting system as extensive as that under HMDA is not likely to be necessary—and indeed a comprehensive data collection system that includes thousands of storefront buyhere/pay here dealers is likely to be impossible—Congress should consider disclosure requirements and other means of making the auto lending industry's practices far more transparent to consumers than they are today.

‣ ***Include financial literacy and credit counseling in welfare-to-work programs.*** The welfare reform law of 1996 was tremendously successful in encouraging many long-term recipients to leave the rolls, enter the workforce, and free themselves from dependence on government. But the job of welfare reform is only half done. Many of the welfare poor are now the working poor, and the second stage of reform demands that policymakers provide welfare leavers with the skills and resources they need to leave poverty altogether.

Financial literacy is crucial to this effort. Getting and keeping a job—even at a living wage—is not sufficient in itself to secure a family's foothold in the middle class. Learning to manage a budget, build credit, and avoid predatory lenders are critical skills for working recipients and leavers making the transition into long-term self-sufficiency. Welfare-to-work programs should include financial literacy and credit counseling as components of their training, and Congress should provide sufficient funding to ensure that quality curricula are available. A few states that have made financial literacy a top priority, notably Delaware and Kentucky, have also developed highly effective financial programs that should be replicated nationally.

- ***Require subprime lenders to report good payment histories.*** Anecdotal evidence indicates that many subprime lenders tend to report only defaults and bad payment histories to credit reporting agencies—if they report anything at all. As a consequence, good borrowers may get no "credit" for paying their bills on time and furthermore are not building the credit and payment histories they need to break out of the subprime market. Congress should modify the Fair Credit Reporting Act or other laws as necessary to require subprime lenders to fairly report the credit behavior of their borrowers.

Conclusion

A principal goal of social policy in the post-welfare reform era is to support and encourage work and to eliminate the barriers that make long-lasting employment difficult for poor workers to achieve. Chief among these barriers is lack of transportation, and any comprehensive effort to make work pay must include a strategy for improving access to transportation, including access to cars.

Basic transportation should not be as expensive as it is for many working poor families. Lack of access to mainstream credit imposes unfair costs on those who are least able to afford it and jeopardizes the prospects of low-income families who are striving to enter the middle class. By making cars less affordable, high-cost financing perpetuates the "transportation gap" between low-income families and the middle class and limits the economic, as well as physical, mobility of low-income workers. As a result, poor workers may find themselves trapped, without adequate access to opportunities for higher-paying or higher-skilled employment. Policymakers should work to ensure the mobility of low-income families—both economic and physical—and protect poor consumers from being taken for a ride.

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[28] See, e.g., Capital One Auto Finance Trust 2002-A (maximum APR: 25.95%); Capital One Auto Finance Trust 2001-B (maximum APR: 24.99%); Capital One Auto Finance Trust 2001-A (maximum APR: 30.00%).
[29] The data in this chart were compiled from the following publicly filed documents: Form 8-K, filed April 11, 2001, for AmeriCredit Automobile Receivables Trust 2000-A; Form 8-K, filed April 11, 2001, for AmeriCredit Automobile Receivables Trust 2000-B; Form 8-K, filed November 14, 2001, for AmeriCredit Automobile Receivables Trust 2000-1; Form 8-K, filed September 13, 2002, for AmeriCredit Automobile Receivables Trust 2001-A; Form 8-K, filed September 13, 2002, for AmeriCredit Automobile Receivables Trust 2002-A; Form 8-K, filed September 13, 2002, for AmeriCredit Automobile Receivables Trust 2002-B; Form 8-K, filed March 13, 2002, for Capital One Auto Finance Trust 2001-A; Form 8-K, filed March 18, 2002, for Capital One Auto Finance Trust 2001-B; Form 8-K, filed August 15, 2002, for Capital One Auto Finance Trust 2002-A; Form 8-K, filed September 19, 2002, for CPS Auto Receivables Trust 1998-4; Form 8-K, filed September 30, 1999, for CPS Auto Receivables Trust 1998-3; Form 8-K, filed May 22, 2002, for Household Automotive Trust III Series 1999-1; Form 8-K, filed May 2, 2002, for Household Automotive Trust VI Series 2000-3; Form 8-K, filed April 18, 2001, for Household Automotive Trust 2001-1; Form 8-K, filed September 30, 2002, for Household Automotive Trust 2001-3; Form 8-K, filed September 30, 2002, for Household Automotive Trust 2002-1; Prospectus Supplement to Prospectus dated May 22, 2002, filed May 29, 2002, for Household Auto Receivables Corp.
[30] Prospectus Supplement dated July 10, 2001, for Capital One Auto Finance Trust 2001-A.
[31] An interesting exception is SeaWest Financial Corporation, a smaller company that engages in bulk purchase of auto receivables. SeaWest specializes in subprime financing to members of the military, and its minimum income requirement for military personnel is $1,000 per month. For civilians, "starter" credit is available for borrowers with a minimum gross monthly income of $1,400, according to the company's website. Other terms of the "starter" credit deal include a maximum term of 36 months, and a 20 percent down payment. The APR is not disclosed, but a footnote states that the applicable APR is the company's standard APR "or state maximum, whichever is less." The company's loan bulk purchase program, however, reveals that the minimum contract APR for loans purchased by the company is 17.95 percent. See *http://www.seawest.com*.
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[33] Form 10-K for the fiscal year ended December 31, 2000, for Consumer Portfolio Services, Inc.
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[58] Form 10-KSB, filed June 29, 2001, for the fiscal year ended March 31, 2001, for Nicholas Financial, Inc.; Form 10-KSB for the fiscal year ended March 31, 2002, filed June 25, 2002.
[59] Form 10-K for the fiscal year ended December 31, 2001, for General Motors Acceptance Corporation. Another example is Union Acceptance Corp., one of the nation's largest independent finance companies, which concentrates primarily on loans to borrowers of higher-quality credit. Union experienced gross charge-offs in fiscal 2001 equal to 6.79 percent of its portfolio. Form 10-K, filed March 29, 2002, for the transition period from July 1, 2001 to December 31, 2001, for Union Acceptance Corp.
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[71] Dynan et al., "Survey of Finance Companies, 2000," *Federal Reserve Bulletin*, January 2002.
[72] HMDA applies to banks, savings associations, credit unions, and other mortgage lending institutions that are larger than the regulation's threshold size. In 2001, 7,713 financial institutions filed loan data on approximately 19 million loans. Information submitted by lenders includes the income level, sex and race of borrowers and applicants, as well as the disposition of a loan application. Using the information submitted by reporting institutions, the Federal Financial Institutions Examination Council (FFIEC) creates reports for each metropolitan area with the purpose of identifying patterns of discriminatory lending and determining whether institutions are adequately serving the borrowing needs of a given community.
[73] "Our Neighborhood Banks: High Cost Loans for Low Income Borrowers," Consumers Union, *http://www.consumersunion.org*, citing Robert W. Johnson and Kent L. Claussen, "Who Borrows from Finance Companies?" American Financial Services Association, (Special Report), p. 15-16. The report adds that in comparison to bank borrowers, finance company clients "hold fewer financial assets, are less likely to pay their credit cards in full and have shorter planning horizons."
[74] See, e.g., "Curbing Predatory Home Mortgage Lending: A Joint Report," U.S. Department of Housing and Urban Development, U.S. Department of Treasury, June 2000.
[75] Diana B. Henriques, "Hidden Charges: A special report; Extra Costs on Car Loans Draw Lawsuits," *The New York Times*, October 27, 2000.
[76] Mark A. Cohen, "Final Report on Racial Impact of Nissan Motor Acceptance Corporation's Finance Charge Markup Policy, In the Matter of Robert F. and Betty T. Cason, et al., v. Nissan Motor Acceptance Corporation (NMAC)," May 17, 2001.