HB
383

ALASKA STATE LEGISLATURE

REPRESENTATIVE LES GARA

HB 383: Regulating Unfair Auto Dealer Practices
Sponsor Statement

House Bill 383 clarifies existing law to protect Alaskan consumers from unfair practices by motor vehicle dealers. The bill provides full, honest disclosure to car buyers who are sometimes misled into paying additional interest and "fees." The first provision of the bill closes a loophole that exists in current law, which allows car dealerships to charge documentation or "doc" fees on top of the negotiated sales price. These fees are not fees paid to any state agency, but rather fees charged to cover certain dealership costs unrelated to the sale of the car such as rent or utility bills.

A loophole exists in AS 45.25.440 that allows dealers to add these "doc fees" back into the sales price if the negotiated price is less than the advertised price. HB 383 requires that if a dealer is going to charge "doc fees," they must be included in the advertised *or negotiated* price. The consumer will be aware that the negotiated price is the final price they will be required to pay.

The second provision of HB 383 limits the practice by car dealers of charging a "dealer reserve." This issue was brought to light by an article in the Anchorage Daily News this summer. A dealer reserve is a percentage of the finance charge that will be received by the car dealership instead of by the bank or lender. For example, a bank may tell the dealership that the lowest interest rate a buyer qualifies for is 4%. The dealership may then charge the buyer 5%, taking 1% for themselves. Under current law, dealers are not required to disclose this information to the buyer.

The bill also addresses the practice many car dealers currently engage in of charging consumers a hidden "dealer reserve" fee. This issue was brought to the public attention in the newspaper last fall when a woman sued Lithia of Anchorage for failing to tell her they were receiving a portion of the interest rate she was offered on a loan. (http://www.adn.com/news/alaska/v-printer/story/7065773p-6970498c.html)

The buyer, an Anchorage woman, was offered 3 interest rates by the dealership when purchasing a used Toyota Tacoma, the lowest of which was 5.95%. She later discovered that the bank, Denali Alaskan Federal Credit Union, had offered a 4.5% interest rate to the dealer. The dealership received the additional percentage, taking over $800 without the buyer's knowledge.

HB 383 would require that if a dealer is receiving a dealer reserve, it must be explicitly stated in a separate portion of the agreement. It must also state how much the dealer is receiving and how much is the actual bank interest rate. The buyer would have to separately sign this portion of the agreement.

Dealers believe that padding the interest rate to make a profit is part of the business. We believe that Alaskan consumers deserve to be fully informed of where their money is going. They should not be misled into believing that the interest rate they've agreed to is the interest rate the bank has offered when that is not the case.

January-May: State Capitol • Juneau, AK 99801-1182 • (907) 465-2647 • Fax (907) 465-3518
June-December: 716 W. 4th Avenue • Anchorage, AK 99501• (907) 269-0106• Fax (907) 269-0109
Representative_Les_Gara@legis.state.ak.us

HOUSE BILL NO. 383

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FOURTH LEGISLATURE - SECOND SESSION

BY REPRESENTATIVE GARA

Introduced: 1/20/06
Referred: Transportation, State Affairs

A BILL

FOR AN ACT ENTITLED

1 **"An Act limiting motor vehicle dealer charges for fees and costs; relating to the**
2 **disclosures required for certain motor vehicle transactions; and requiring consumers to**
3 **be informed of finance charges paid to a motor vehicle dealer by a financing institution**
4 **on the sale of a used motor vehicle."**

5 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

6 *** Section 1.** The uncodified law of the State of Alaska is amended by adding a new section
7 to read:
8 LEGISLATIVE INTENT. The intent of this Act is to clarify existing law relating to
9 motor vehicle dealer charges for fees and costs, the disclosures required for certain motor
10 vehicle transactions, and the disclosure of finance charges paid to a motor vehicle dealer by a
11 financing institution on the sale of a used motor vehicle.
12 *** Sec. 2.** AS 45.25.440 is amended to read:
13 **Sec. 45.25.440. <u>Additional fees and costs</u> [ADVERTISED PRICE].** (a)
14 When selling a motor vehicle, a motor vehicle dealer may not charge <u>any</u> [DEALER]

1 fees or costs **in addition to the advertised or negotiated price**, except for fees
2 actually paid to a state agency for licensing, registration, or title transfers [, UNLESS
3 THE FEES OR COSTS ARE INCLUDED IN THE ADVERTISED PRICE].
4 (b) In this section, "[DEALER] fees or costs" includes dealer preparation fees,
5 document preparation fees, surcharges, and other [DEALER-IMPOSED] fees and
6 costs.
7 * **Sec. 3.** AS 45.25.610(c) is amended to read:
8 (c) If a motor vehicle dealer arranges financing for a buyer, the motor vehicle
9 dealer may deliver the motor vehicle to the buyer before final approval by the
10 financing entity if
11 (1) the buyer and seller sign an agreement separate from the motor
12 vehicle installment contract on an 8 1/2 x 11 inch sheet of paper that clearly and
13 conspicuously informs the buyer that final financing arrangements have not yet been
14 approved and that clearly sets out the amount that will be financed, the annual
15 percentage rate of the finance charge, the amount of the finance charge, the number
16 and frequency of payments, and the amount of each payment;
17 (2) the separate agreement **in (1) of this subsection** clearly and
18 conspicuously informs the buyer that accepting delivery of the vehicle before final
19 financing approval obligates the buyer to terms of the motor vehicle sales contract if
20 the terms on the separate agreement are identical to the terms finally approved by the
21 financing entity; [AND]
22 (3) **the motor vehicle dealer complies with the disclosure**
23 **requirements of (f) of this section; and**
24 **(4)** the separate agreement **in (1) of this subsection** provides that the
25 separate agreement, the motor vehicle sales contract, and any and all other conditions
26 of the purchase will be void if any of the terms contained in the separate agreement are
27 changed by either the motor vehicle dealer or the financing institution as a condition
28 of sale or final financing approval.
29 * **Sec. 4.** AS 45.25.610 is amended by adding a new subsection to read:
30 (f) In addition to the other requirements of this section, if a motor vehicle
31 dealer sells a used motor vehicle and a lender other than the motor vehicle dealer will

1 provide the buyer's financing for the purchase, the motor vehicle dealer shall disclose,
2 if applicable, in a written statement, that the motor vehicle dealer will receive a
3 portion of the finance charge the buyer will pay to the lender and the total amount the
4 motor vehicle dealer will receive. In addition to any other signature required, the buyer
5 shall separately sign the statement or portion of the statement that contains this
6 disclosure.

24-LS1287\L
Bannister
2/2/06

CS FOR HOUSE BILL NO. 383( )

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FOURTH LEGISLATURE - SECOND SESSION

BY

Offered:
Referred:

Sponsor(s): REPRESENTATIVE GARA

A BILL

FOR AN ACT ENTITLED

1 **"An Act relating to motor vehicle dealer charges for fees and costs; relating to the**
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14 [WHEN SELLING A MOTOR VEHICLE, A] motor vehicle dealer may not charge

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1 [DEALER] fees or costs **in addition to the advertised or negotiated price**, except
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3 unless **the motor vehicle dealer discloses in writing to the buyer before a sales**
4 **contract under AS 45.25.610 is entered into that the buyer may negotiate**
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18 approved and that clearly sets out the amount that will be financed, the annual
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Bannister
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12 disclosure.

Cody Rice

From: Rick Morrison [rick.morrison@morrisonautogroup.com]
Sent: Friday, February 03, 2006 11:48 AM
To: Cody Rice
Subject: FW: In the interest of increasing consumer awareness, the National Automobile Dealers Association encour

In the interest of increasing consumer awareness, the National Automobile Dealers Association encourages and supports a clear written disclosure to consumers:

(1) that the annual percentage rate (APR) for the installment sale of an automobile may be negotiated with the dealership; and

(2) that the dealership may receive some portion of the finance charge or receive other compensation for providing the financing.

Legis already has rules w/ it

Especially Smith A.G. Office AS 45.25?

See Disclosure from Rick
remove sec 4
p.2 in addition to adv price
"or negot price"

Fair Trade Practice
clean up work east of
adv. price must include am
$ to dealer

Ed Sniffen —
269-5220 -
276-8554 -

45.25.440
Truth in lending act
Collusion

May not be the lowest interest rate available. —

Alaska State Legislature
Representative Carl Gatto

600 E Railroad Ave* Wasilla, Alaska 99654 * Phone 907-376-3725 * Fax 907-465-2381

Facsimile Cover Sheet

From:	Cody Rice
To:	Rick Morrison
Company:	Morrison Auto Group
Phone:	907-272-5522
Fax:	907-277-3026
Date:	02/03/06
Number of pages (including cover):	4

This fax is for Rick Morrison. Rep. Gatto has scheduled a hearing on HB 383 – "An Act relating to motor vehicle charges." I have attached the Transportation Committee substitute we will introduce. Please let me know ASAP if you have any questions, comments, or concerns. The hearing will be Tuesday, February 7th at 1:30pm. Thanks for your help and information.

Cody Rice

Co-Chair – House Transportation Committee
Vice-Chair – House HESS Committee
Vice-Chair – House Labor and Commerce Committee

24-LS1287\I
Bannister
1/27/06

CS FOR HOUSE BILL NO. 383( )

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FOURTH LEGISLATURE - SECOND SESSION

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Offered:
Referred:

Sponsor(s): **REPRESENTATIVE GARA**

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11 statement or portion of the statement that contains this disclosure.

For Release: February 27, 2004

FTC Releases Staff Report on Mortgage Broker Compensation Disclosures

On October 28, 2002, the Federal Trade Commission staff submitted comments to the Department of Housing and Urban Development (HUD) on its July 2002 Real Estate Settlement Procedures Act (RESPA) reform proposal. The FTC staff generally supported the RESPA reform proposal, including rules that would permit the packaging of settlement services; make the Good Faith Estimate disclosure form more understandable and easier to use for consumers; and increase the certainty of settlement cost estimates given to consumers. The FTC staff raised concerns, however, about the requirement that mortgage brokers (but not other mortgage providers) must disclose certain types of compensation.

The FTC's Bureau of Economics today released a staff report titled "The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment." The report presents the results of a study that examines the mortgage broker compensation disclosure proposed by HUD, as well as two alternative versions. The study finds that the disclosures are likely to confuse consumers, cause a significant number of consumers to choose loans that are more expensive than the available alternatives, and create a substantial consumer bias against broker loans, even when the broker loans cost the same or less than direct lender loans.

The study notes that a major part of mortgage broker compensation, and the focus of the proposed disclosure, is any yield spread premium (YSP) paid by the lender for a loan originated at an above-par (premium) interest rate. The YSP reflects the additional value to the lender of a loan originated at the higher interest rate. Lenders making loans directly to consumers may charge the same interest rate and earn the same compensation as a mortgage broker but would not be required to make the same disclosure under the proposed policy.

The study examines the disclosures in a controlled experiment with more than 500 recent mortgage customers. Participants were shown cost information about two hypothetical mortgage loans and asked to identify which loan was less expensive and which loan they would choose if they were shopping for a mortgage. Participants were divided into five groups. A broker compensation disclosure was included in the cost information shown to three of the groups, with the format and wording of the disclosure varying across the groups. In each of the groups, one loan was treated as a broker loan and one as a direct lender loan. The broker loan disclosed a YSP amount but the direct lender loan did not, following the policy proposed by HUD. A broker compensation disclosure was not included in the cost information shown to the other two groups.

In the two groups shown cost information without a broker compensation disclosure, about 90 percent of the respondents in each group correctly identified the less expensive loan, and 85 percent and 94 percent identified the less expensive loan as the one they would choose if they were shopping for a mortgage. Only 3 percent of the respondents in one of the groups identified the more expensive loan as the one they would choose if shopping. Others said they would choose either, neither, or did not know.

In contrast, in the three groups shown cost information that included a broker compensation disclosure, only 63 percent to 72 percent of the respondents correctly identified the less expensive loan, and only 60 percent to 70 percent identified the less expensive loan as the one they would choose if they were shopping for a mortgage; 16 percent to 27 percent identified the more expensive loan as the one they would choose if shopping. The study concludes that the consumer confusion and mistaken loan choices arising from the compensation disclosure are likely to increase mortgage costs for many consumers.

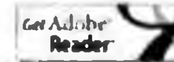
The study also included tests in which both loans cost the same. In the two groups shown cost information without a broker compensation disclosure, 95 percent and 99 percent of the respondents correctly recognized that both loans cost the same, and 78 percent and 83 percent said they would choose "either loan, both cost the same" if they were shopping for a mortgage. The few respondents who chose one of the two loans split fairly evenly between the two.

In contrast, in the three groups shown cost information that included a broker compensation disclosure, 40 percent to 50 percent of the respondents mistakenly believed that one loan was less expensive than the other, and of these, 75 percent to 90 percent believed that the direct lender loan (that did not disclose a YSP) was less expensive than the broker loan (that did disclose a YSP).

Related Documents:

The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment
A Bureau of Economics Staff Report (January 2004)

- Full Report [PDF 2.9M]
- Executive Summary [PDF 261K]
- Text of the Report [PDF 1.1M]
- Appendices [PDF 1.14M]
- Request Mailed Copy of Report



Similar results, with an even larger bias against the broker loan, were found when these respondents were asked which loan they would choose if shopping for a mortgage. The study concludes that the bias against broker loans arising from the asymmetric compensation disclosure may harm competition in the mortgage market and result in higher mortgage costs for consumers.

The study concludes that a better way to help consumers obtain less expensive mortgages would be to encourage and facilitate comparison shopping on loan costs. This approach is incorporated in other components of HUD's RESPA reform proposal and would be far more beneficial for consumers. Implementation of these policies, along with appropriate refinements to ensure that consumers easily understand the disclosures, would provide benefits to consumers without the adverse effects that are likely to arise from the compensation disclosure.

Copies of the report are available on the FTC's Web site at www.ftc.gov and also from the FTC's Bureau of Economics at 202-326-2361, or requests can be e-mailed to troundtree@ftc.gov. The FTC works for the consumer to prevent fraudulent, deceptive and unfair business practices in the marketplace and to provide information to help consumers spot, stop and avoid them. To file a complaint, or to get free information on any of 150 consumer topics, call toll-free, 1-877-FTC-HELP (1-877-382-4357), or use the complaint form at http://www.ftc.gov. The FTC enters Internet, telemarketing, identity theft and other fraud-related complaints into Consumer Sentinel, a secure, online database available to hundreds of civil and criminal law enforcement agencies in the U.S. and abroad.

*The report's authors are James M. Lacko and Janis K. Pappalardo of the FTC's Bureau of Economics. The views expressed in the report are those of the authors and do not necessarily represent the views of the Federal Trade Commission or any individual Commissioner.

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(http://www.ftc.gov/opa/2004/01/mortgagerpt.htm)

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24-LS1287\S
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CS FOR HOUSE BILL NO. 383( )

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New Text Underlined [DELETED TEXT BRACKETED]

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18 separate agreement, the motor vehicle sales contract, and any and all other conditions
19 of the purchase will be void if any of the terms contained in the separate agreement are
20 changed by either the motor vehicle dealer or the financing institution as a condition
21 of sale or final financing approval.
22 * **Sec. 3.** AS 45.25.610 is amended by adding a new subsection to read:
23 (f) In addition to the other requirements of this section, if a motor vehicle
24 dealer sells a used motor vehicle and a lender other than the motor vehicle dealer will
25 provide the buyer's financing for the purchase, the motor vehicle dealer shall disclose,
26 if applicable, in a written statement, that the interest rate offered by the motor vehicle
27 dealer may not be the lowest interest rate available. In addition to any other signature
28 required, the buyer shall separately sign the statement or portion of the statement that
29 contains this disclosure.

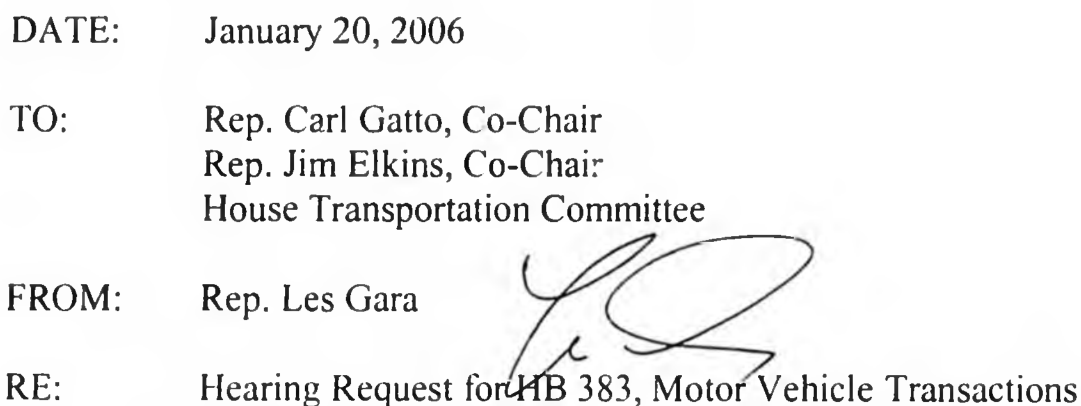
ALASKA STATE LEGISLATURE

REPRESENTATIVE LES GARA

MEMORANDUM

DATE: January 20, 2006

TO: Rep. Carl Gatto, Co-Chair
Rep. Jim Elkins, Co-Chair
House Transportation Committee



FROM: Rep. Les Gara

RE: Hearing Request for HB 383, Motor Vehicle Transactions

I respectfully request that House Bill 383, relating to fees charged to consumers by motor vehicle dealers, be scheduled for a hearing in the House Transportation Committee. Please feel free to contact me, or my aide Emily McCoy, with questions or thoughts at 465-2647.

Attached you will find a background packet for HB 383. This includes the current version of the bill, a sponsor's statement, and backup materials.

Thank you for your consideration.

January-May: State Capitol • Juneau, AK 99801-1182 • (907) 465-2647 • Fax (907) 465-3518
June-December: 716 W. 4th Avenue • Anchorage, AK 99501• (907) 269-0106• Fax (907) 269-0109
Representative_Les_Gara@legis.state.ak.us

ALASKA STATE LEGISLATURE

REPRESENTATIVE LES GARA

HB 383: Regulating Unfair Auto Dealer Practices
Sponsor Statement

House Bill 383 clarifies existing law to protect Alaskan consumers from unfair practices by motor vehicle dealers. The bill provides full, honest disclosure to car buyers who are sometimes misled into paying additional interest and "fees." The first provision of the bill closes a loophole that exists in current law, which allows car dealerships to charge documentation or "doc" fees on top of the negotiated sales price. These fees are not fees paid to any state agency, but rather fees charged to cover certain dealership costs unrelated to the sale of the car such as rent or utility bills.

A loophole exists in AS 45.25.440 that allows dealers to add these "doc fees" back into the sales price if the negotiated price is less than the advertised price. HB 383 requires that if a dealer is going to charge "doc fees," they must be included in the advertised *or negotiated* price. The consumer will be aware that the negotiated price is the final price they will be required to pay.

The second provision of HB 383 limits the practice by car dealers of charging a "dealer reserve." This issue was brought to light by an article in the Anchorage Daily News this summer. A dealer reserve is a percentage of the finance charge that will be received by the car dealership instead of by the bank or lender. For example, a bank may tell the dealership that the lowest interest rate a buyer qualifies for is 4%. The dealership may then charge the buyer 5%, taking 1% for themselves. Under current law, dealers are not required to disclose this information to the buyer.

The bill also addresses the practice many car dealers currently engage in of charging consumers a hidden "dealer reserve" fee. This issue was brought to the public attention in the newspaper last fall when a woman sued Lithia of Anchorage for failing to tell her they were receiving a portion of the interest rate she was offered on a loan. (http://www.adn.com/news/alaska/v-printer/story/7065773p-6970498c.html)

The buyer, an Anchorage woman, was offered 3 interest rates by the dealership when purchasing a used Toyota Tacoma, the lowest of which was 5.95%. She later discovered that the bank, Denali Alaskan Federal Credit Union, had offered a 4.5% interest rate to the dealer. The dealership received the additional percentage, taking over $800 without the buyer's knowledge.

HB 383 would require that if a dealer is receiving a dealer reserve, it must be explicitly stated in a separate portion of the agreement. It must also state how much the dealer is receiving and how much is the actual bank interest rate. The buyer would have to separately sign this portion of the agreement.

Dealers believe that padding the interest rate to make a profit is part of the business. We believe that Alaskan consumers deserve to be fully informed of where their money is going. They should not be misled into believing that the interest rate they've agreed to is the interest rate the bank has offered when that is not the case.

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June-December: 716 W. 4th Avenue • Anchorage, AK 99501• (907) 269-0106• Fax (907) 269-0109
Representative_Les_Gara@legis.state.ak.us

ALASKA STATE LEGISLATURE

REPRESENTATIVE LES GARA

HB 383: Regulating Unfair Auto Dealer Practices
Sectional Analysis

Section 1.

Legislative Intent – states that intent is to clarify existing law regarding disclosures by car dealers.

Section 2.

Clarifies law to state that fees and costs not paid to a state agency may not be charged unless included in advertised or negotiated price.

Section 3.

Requires that if a dealer is charging a "dealer reserve" fee, it must be disclosed and the consumer must agree to it by signing a separate statement.

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June-December: 716 W. 4th Avenue • Anchorage, AK 99501• (907) 269-0106• Fax (907) 269-0109
Representative_Les_Gara@legis.state.ak.us

Emily McCoy

From: Ed Sniffen [Ed_Sniffen@law.state.ak.us]

Sent: Thursday, January 19, 2006 8:57 AM

To: Emily McCoy

Subject: Auto Legislation

Hey Emily. Thanks for faxing a copy of Les' Bill regarding motor vehicle fees and costs. Here's the short explanation of how auto dealers are getting around the documentation fees ("doc fees") restriction currently found in AS 45.25.440. The current version of the statute requires all doc fees to be included in the advertised price. Here's what happens:

Dealer advertises a vehicle for $29,999. This advertised price includes all doc fees. Customer goes to dealer and negotiates a lower price — let's say $27,000. The salesman says "great, we have a deal." Then, when all the paperwork is filled out, the $199 doc fee is added to the $27,000 price. The current statute allows this because the dealer included the doc fee in the advertised price. But as soon as negotiations start and the advertised price is no longer on the table for negotiation, dealers can add it back in.

Doc fees are particularly troublesome because consumers believe they are fees paid to the state. In fact, these fees are nothing more than overhead (like rent, utility bills, or janitorial service). Les' bill solves this problem by requiring that all fees and costs must be included in the advertised or "negotiated" price.

Hope that helps!

ED

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Anchorage Daily News

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Buyer sues dealer over finance charges

Dealership offered woman higher loan rate, kept part as profit

By PAULA DOBBYN
Anchorage Daily News
(Published: October 9, 2005)

Erica Hobson's lawsuit against Lithia of Anchorage began after her brother noticed signs that her truck had been wrecked before, a fact that wasn't made known to her. *(Photo by BILL ROTH / Anchorage Daily News)*

Erica Hobson bought her dream pickup truck at the right price. Or so she thought.

But the Anchorage woman is in court now, trying to end a practice that the Consumer Federation of America estimates costs car buyers nationwide hundreds of millions of dollars in extra finance costs. Hobson's experience is a cautionary tale for anyone planning to buy a car.

Hobson, 27, spotted a shiny Toyota Tacoma pickup in a Midtown Anchorage dealer's lot during her lunch hour. Later that day in June 2004, she test-drove the used silver-colored truck, made a down payment, signed loan papers for $23,797 and drove the vehicle home.

"I was really excited," Hobson recalled. "I thought, 'I'll have this Toyota for the next 15 years.' "

Her elation turned to disbelief when Hobson's brother inspected the 2003 truck a week later. The professional auto painter noticed tell-tale signs that the truck had been wrecked: He noticed it had been repainted and parts had been replaced.

Hobson, a paralegal, is suing the dealer, Lithia of Anchorage, for triple damages, which her attorney estimated at $99,265.68.

Lithia's attorney, June Rohlf, would not comment, saying the company does not discuss pending litigation. In court filings, Lithia acknowledged selling Hobson a vehicle that had sustained damage without revealing that to her. But the company did not engage in deceptive practices or intend to mislead Hobson about the car, Rohlf said in court papers.

The lawsuit has evolved from a case about failure to disclose damage to a vehicle to one that takes on a widespread but little known aspect of auto financing. Hobson claims that Lithia deceived her about the loan interest rate for which she qualified, raising her monthly loan payments and giving Lithia a secret extra payment.

If Hobson wins, she hopes her case will end in Alaska a practice among car dealers and banks called "dealer reserve." It's a practice that can add hundreds, or thousands, of dollars in hidden costs to car buyers.

"You go into these dealerships thinking you can trust that what they represent to you is accurate. While you might expect to dicker, you come to find out that the system is designed to take advantage of you any way it can," Hobson said recently.

Dealers say there's nothing illegal about padding a little extra on to the interest rate. It's a way of compensating themselves for arranging the financing, saving people time and sometimes securing the customer a better rate than they could have gotten on their own.

Consumer interest groups like Public Citizen say hogwash.

"Car-dealer fraud is plaguing our country. The tactics being used are so [illegible] that even informed consumers who do their homework are being taken for hundreds, and often thousands, of dollars," said Public Citizen when it issued a 2003 report titled "Rip-off Nation: Auto Dealers' Swindling of America."

THE DEAL

Hobson says her experience has taught her that financing terms on car loans are just as negotiable as the sales price, and that by getting buyers to accept higher interest rates dealers can boost their profits.

But that knowledge came painfully.

Lithia quoted Hobson three different interest rates before she agreed to accept the lowest one offered: 5.95 percent.

The loan came from Denali Alaskan Federal Credit Union.

But 5.95 percent wasn't the lowest interest rate that Denali said Hobson qualified for. Denali quoted to Lithia a rate of 4.5 percent, according to court filings.

"At no time did Lithia advise plaintiff that Denali had offered a 4.5 percent interest rate on the loan, or that Lithia was going to or did increase the loan interest rate an additional 1.45 percent in order to earn a 'dealer reserve' payment from Denali," Hobson's attorneys said in court papers.

By signing up for the 5.95 percent interest rate, Hobson in effect agreed to pay an extra $1,100 over the life of her six-year loan.

Denali paid Lithia $836.64 for signing up Hobson at the higher interest rate, according to paperwork Hobson's lawyers acquired through legal discovery.

In her answer to Hobson's complaint, Rohlf defended the practice of dealer reserves.

"Many courts that have considered this issue agree that there is nothing illegal, deceptive or unfair about 'dealer reserve' practices, and that there is no obligation to disclose the information to customers," Rohlf wrote in court papers.

All financial institutions that work with car dealerships use dealer reserves, said Denali Alaskan spokesman Keith Fernandez on Friday.

While people can generally get better rates if they come into a branch and arrange financing themselves, Denali Alaskan "does view indirect lending as a service to members who don't want to run back and forth between the institution and a dealer to buy a car," Fernandez said.

Several spokespersons for Alaska banks and credit unions said their businesses no longer engage in dealer reserves or never did.

THE WAY IT WORKS

Lawyers and consumer advocates who have studied auto-lending practices say the dealer reserve formula is fairly standard and goes something like this:

Car dealers and lenders form alliances. The bank or credit union agrees to buy car loans from the dealer at a range of interest rates based on the purchaser's creditworthiness. The lowest one the car buyer qualifies for is called the "buy rate."

If the loan is made at the buy rate, the dealer doesn't get any commission.

However, if the dealer gets the purchaser to accept a higher interest rate, the difference between the buy rate and the agreed-on rate is called the spread premium. This premium -- which critics call a kickback and others call a reserve -- is usually split between the car dealer and the lender. Usually the dealer gets a bigger slice, according to consumer advocates.

Dealers rarely disclose this arrangement because they are not required to do so, critics say.

"These hidden finance kickbacks typically add at least $1,000 to the cost of an auto loan, and are costing consumers as much as one billion dollars annually," Stephen Brobeck, executive director of the Consumer Federation of America, said last year when his organization issued a report on the subject.

IS IT FAIR?

Dealers generally say the reserves they receive are payment for a useful service they provide to customers. They save people the hassle of finding their own financing. They complete a lot of paperwork so all people have to do is sign on the bottom line.

Because of their relationships with lenders, dealers also say they can often get loans for people who otherwise wouldn't qualify, or they can get them better interest rates.

"A lot of times it's not a bad thing because with our buying power we can often get a cheaper interest rate," said Calvin Worthington Jr. of Worthington Ford, a large auto dealer in Anchorage. "We often know about bank specials that are published only to dealers and are not made known to the general public."

But dealers clearly feel under attack by recent high-profile media coverage about dealer reserves, namely "60 Minutes" and "Dateline" pieces.

"Dealer financing is getting a bad rap. A recent wave of negative media reports has focused attention on vocal critics of dealer markups who have called for legislation that would impose either a flat fee or a cap on dealer compensation for obtaining credit for car buyers," said Charley Smith, chairman of the National Automobile Dealers Association, in a speech last year.

Smith said dealers shouldn't hide under their desks but respond by educating people about auto financing, he said. The association's board voted to support disclosing to customers that the finance rate is negotiable and that the dealer may retain part of the finance charges as compensation for helping the buyer secure a loan.

SEEKING RELIEF

Consumer education by auto dealers is fine, but Hobson wants relief for what she went through.

She continues to drive a pickup that was wrecked and worries about her safety if she gets into a crash. If she tried to sell it and properly disclosed the previous damage, Hobson estimates she could get barely half of what she paid for it.

Besides getting her money back and possibly damages, Hobson really wants other people to avoid her experience.

One of her attorneys, Chris Bataille, said Alaska's consumer protection law is strong and that bodes well for his client.

"Our understanding of the law is that businesses shouldn't engage in practices that mislead consumers," Bataille said.

Lithia's attorney said in court papers that nothing misleading took place and that Hobson was not required to accept the 5.95 percent interest rate if she didn't want to.

Trial is scheduled for Nov. 28.

Daily News reporter Paula Dobbyn can be reached at pdobbyn@adn.com or 257-4317.

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Competitive Forces Operating in the Market for Automobile Loans

April 2005

by

James S. Grichar, Ph.D.*

Economic evidence shows that automobile dealers are not charging higher interest rates on loans to customers than those charged by banks or other financial institutions. Increased competition among lenders, significant improvements in the availability and accuracy of financial information, and new ways of raising funds have made the market for automobile loans economically more efficient, thus assuring consumers that they are getting auto loans at the lowest possible cost. In fact, in the last four and one-half years, the interest rate charged on popular 36-month and 48-month loans for new cars, after taking account of the higher net loss rate on auto loans, has fallen compared to the risk adjusted 30-year fixed rate conventional mortgage. Such a decline is highly indicative of the fact that consumers are getting a fair deal when taking out an auto loan. This risk-adjusted competitive pricing of loans exists whether the loan is written at a franchised auto dealer or at a financial institution.

Gains for Consumers

Increased competition in the consumer lending industry and improved information available to borrowers have increased the availability of credit to consumers and also driven down the profit margins of lenders over the last thirty - forty years. The U.S. Congress passed and the President signed into law the Consumer Credit Protection Act of 1968, which mandated that all lenders disclose effective costs to potential borrowers before they sign a loan agreement. Included in these disclosures are such items as the total amount of dollar payments needed to be made on the loan, the monthly payment needed to be made (including all fees and other charges), the total finance charges (including all interest or interest-equivalent items), and the effective annual percentage rate being charged. The Federal Reserve Board issues regulations and specifies the "Truth in Lending" forms that lenders must give to prospective borrowers before they sign a loan agreement. This gives the prospective borrower a chance to review the terms of the loan and decide, before signing any loan agreement, whether or not the effective interest rate being charged is too high. In other words, a prospective borrower legally gets a major part of the information necessary to make an informed decision on whether or not he or she is getting a fair

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* Ph.D. in Economics, University of Wisconsin. Consulting Economist; formerly Senior Economist, Federal Emergency Management Agency (1985 – 2001), Chief Economist, U.S. Base Closing Commission (1991), and Director, Board of Directors, University National Bank, Milwaukee, Wisconsin (1972-1974); Graduate with Distinction, Industrial College of the Armed Forces, National Defense University (1984).

interest rate on a loan. This law and the accompanying regulations apply to all lending operations, including loans made by automobile dealers.

With increased competition from lending institutions operating in all credit markets, information has become cheaper, i.e., easier to find, regarding the effective interest rates paid on loans from alternative lenders. This development has followed a competitive path similar to that of mortgage lending for residential housing, where information on loan terms has become more available and the costs of acquiring such information for potential borrowers has fallen significantly, just as they have for someone examining options for financing the purchase of a home or the refinancing of an existing mortgage. Today, a prospective automobile buyer - in the space of 30 - 60 minutes - can gather adequate information on the costs of auto loans from alternative lenders to determine whether or not a prospective interest rate being offered by an automobile dealer is competitive or not. This information is obtained by calling various financial institutions, reading brochures, talking to officers at local banks, or researching on the Internet.

Consumers have also benefited from an increase in the number of sources for financing automobile purchases. Thirty or forty years ago, consumers either obtained financing for an automobile purchase through a dealer or through a bank or finance company. Today, automobile loans are also available from the large and growing credit union sector, savings banks (formerly savings and loans, which used to be restricted to mortgage lending only), loans from stock brokerage firms, and more recently through the use of home equity loans, the interest on which may often be tax deductible. This additional competition, particularly from home equity loans, has forced those lending in the automobile sector to cut their profit margins on such loans, at least to those who have better credit ratings and who have better personal balance sheets with greater net worth.

Because of changes in other federal laws, consumers now have ready access to their credit rating - which means that they have the ability to know how they will be judged by potential lenders before they apply for a loan. Such information includes payment histories on loans for a long time period as well as credit card and other debt outstanding. A person can then know that if they have a good credit rating, they should be able to obtain an auto loan at an interest rate with a fairly low risk premium - that is, at an interest rate low enough to reflect their good credit standing. Those with poor credit ratings - and a poorer likelihood [illegible] repaying an auto loan - would naturally have to pay a higher interest rate because of the greater chance that they might default on the loan, thus necessitating a costly repossession action on the part of the lender that held a security interest in the vehicle.

Consumers are now more financially astute than they were forty years ago, and they actively shop around to obtain the best terms on loans. According to a study published in the July 2003 Federal Reserve Bulletin entitled "Household Financial Management: The Connection between Knowledge and Behavior," (a survey of consumers was taken in November and December of 2001), 58 percent of the respondents reviewed their credit reports. Such behavior indicates that many potential borrowers are paying attention to their credit situation and are likely to investigate credit options before making a decision to borrow. And according to Richard Hynes and Eric A.

Posner ("The Law and Economics of Consumer Finance," Working Paper No. 117 of the John M. Olin Law and Economics program at the University of Chicago Law School - Feb., 2001 - available for download at http://www.law.uchicago.edu/Publications/Working/index.html), "... if enough consumers compare loans before borrowing, no lender could make a profit by lending only to those who did not compare. However, by shopping the informed consumers effectively confer a positive externality on the uninformed, ..." (Referenced article, p. 6). What this means is that a relatively large number of consumers who shop around for the best loan rates are sufficient to bring down rates for all borrowers, including those who do not investigate the costs of auto loan credit outside of the dealer selling the vehicle. Thus, the greater the number of informed consumers who investigate alternative sources of financing before buying a car, the more likely that even the financially ignorant will benefit by getting a lower interest rate loan.

Lenders Get More Efficient

Increased competition among all lenders has brought about increased efficiencies in providing automobile loans to borrowers, thus enabling lenders to provide loans to borrowers at a much lower markup - or spread - over their cost of funds.

First of all, the availability of credit information on prospective borrowers - generated by the mortgage lending sector and the credit card sector- has made it much easier and less costly for other lenders - automobile loans, and personal loans from finance companies - to gauge a prospective borrower's credit worthiness. This has helped to reduce the spread on auto loans - that is, it has lowered the gross margin required over the cost of funds. Even under some bad cases, consumer credit - via credit card loans - is available to a borrower with a poor credit history at interest rates approaching 20-24%. Loans with an automobile as security generally would never likely equal, let alone exceed, such unsecured credits. And for an auto loan issuer - whether dealer, bank, or other financial institution - to charge such an effective rate to a borrower would be a direct indication of the borrower's extremely poor credit rating.

And with information on interest rates so readily available, no lender can afford to alienate potential customers by trying to charge excessive spreads over their cost of funds. Inter-dealer competition for car sales also assures that dealers will not charge higher than market rates for auto loans.

Dealers have actively promoted the use of low-cost manufacturer financing. Following strict credit worthiness guidelines set up by the manufacturer's financing subsidiary, dealers pass on to customers this lower-cost financing. The manufacturer's financing subsidiary - with tremendous borrowing power - can acquire large amounts funds on capital markets by selling short- to intermediate-term bonds that are backed by the auto loans, and hence, by the cars themselves. This securitization of auto loans - standardizing the terms so as to package them into groups that can be used to back the bonds issued by the manufacturer's finance subsidiary - have brought down the markup, or margins, over the cost of the funds and have thus made loans relatively less expensive for consumers when borrowing from a dealer.

Banks and other finance companies are also able to securitize the auto loans that are on their books. They do this, as do other lenders, by setting up uniform credit scoring standards for prospective auto loan customers, regardless of what part of the country they live in. This makes it easier for credit rating agencies to rate notes and bonds backed by auto loans, an important factor in making such notes and bonds attractive to investors. This securitization, whether by banks and finance companies or by the financial subsidiaries of automobile manufacturers, allows funds to flow more readily into automobile loans, bringing down the interest rate charged to borrowers because more investors are interested in purchasing the notes backed by high quality auto loans.

Simply put, securitization of auto loans is similar to what has taken place in the mortgage lending sector over the last thirty - forty years where mortgage originators sell their mortgages to such organizations as Fannie Mae and Freddie Mac, who then sell securities to large institutional investors such as insurance companies, pension funds, mutual funds and wealthier private investors. These securities sold are backed by the original mortgages, which have been assembled into a package that matches the maturity and interest rate of the bonds they have sold.

The market for securitized auto loans is immense. According to the Bond Market Association (http://www.bondmarkets.com/research), at the end of the first quarter of 2004, outstanding bonds securitized by auto loans totaled over $238 billion, and this represented 13.6% of all asset-backed securities issued in the United States. Organizations that issue notes backed by automobile loans include Bank One, Americredit, the Associates, Household International, Chase Manhattan (predecessor of J.P. Morgan Chase), BMW, Daimler-Chrysler, Ford Credit, Honda, Nissan, Onyx Acceptance, SSB, Capital One, General Motors Acceptance Corporation (GMAC), and others. And savers - whether at a lower income level or a higher income level - can now earn higher interest rates by channeling their funds into savings instruments backed by auto loans. Lower income savers can do so by purchasing mutual funds, whereas higher-income savers can often purchase such notes and bonds directly from their brokers.

The Evidence

Interest rates charged on different types of loans - including bond issues - reflect the length of the loan or term of the bond and the risk that the specific borrower or issuer of the bond will go bankrupt and not be able to pay the interest and/or repay the principle. Normally, interest rates charged on short-term loans or notes are the lowest, with long-term loans or bond issues getting the highest interest rate or yield. This situation is often referred to as representing a normal yield curve. The longer the term to maturity, the greater the risk the borrower might default or that the bond holder would have to sell the security (or for a bank to find some other bank or financial institution to buy the loan) at a loss because interest rates could rise in the future. Even U.S. Treasury securities, which have no risk of default, are subject to the risk of capital loss if interest rates rise, and this is particularly true as the maturity of the security gets longer.

U.S. government securities have another general advantage over privately-issued bonds and loans, and that is that the Federal Reserve - the nation's central bank - would buy up large

amounts of these securities in the event of a financial panic to prevent a recession or depression. Just as important, the Federal Reserve on a daily basis purchases and sells the shorter-term Treasury notes to manage the nation's money and credit supplies. Over time, these two advantages - no default risk and the actions of the Federal Reserve in buying U.S. government securities to expand the money and credit supplies - gives the U.S. government a significant advantage in terms of interest costs over privately-issued notes and bonds.

An example of the yield curve for U.S. Treasury securities can be seen in Chart 1, which depicts the yields on various maturities for July 16, 2004. Given the observations of actual interest rates, which have been adjusted to indicate what they would be for a given maturity, it is possible to draw a line between those observations to get an idea of what the yield curve looked like on that date.

Chart 2 is similar to Chart 1 in that it shows the same yield curve for U.S. Treasury securities, but it also depicts interest rates charged on prime new car loans, both for the 36 and 48 month terms, as reported by bankrate.com, a subsidiary of Dow Jones, the publisher of The Wall Street Journal. The interest rate on prime new car loans represents the rate charged to borrowers with the highest credit rating. Auto loan interest rates are not subsidized in any way by the federal government, so the rate shown is unsubsidized. Chart 2 also shows the rate on the 30-year conventional fixed rate mortgage, as reported weekly by the Federal Reserve Board, and this rate was 6% on July 16, 2004.

One area in which mortgages have an advantage compared to auto loans is that the federal government subsidizes the mortgage market by giving special privileges to the Federal National Mortgage Association (known as Fannie Mae) and the Federal Home Loan Mortgage Corporation (now known formally as Freddie Mac), all with the goal of promoting home ownership.

These organizations promote home ownership by selling bonds and using the proceeds to buy mortgages from mortgage banks and other financial institutions that make mortgage loans. According to a May 2001 study by the U.S. Congressional Budget Office (CBO) entitled "Federal Subsidies and the Housing GSE's" (government sponsored enterprises), the federal government chartered these institutions (www.cbo.gov/showdoc.cfm?index=2841&sequence=0). While both are stock companies, the federal government has provided a significant cost break for these entities by exempting them from state and local income taxes and by exempting them from registering securities with the Securities and Exchange Commission (SEC) and from paying the associated SEC fees. They can also use the Federal Reserve as their fiscal agent - meaning that they can use the Federal Reserve to manage payments on their bonds.

The federal government has a significant influence on their day to day operations, and this is in the form of picking certain senior officials (in the case of Fannie Mae) or in the more important area of providing an implicit bail-out of these companies' bonds if they should ever be on the verge of defaulting. It is this bail-out subsidy that has in part cut the interest rates that they have to pay on the bonds they issue, since most investors believe that the Treasury would provide

loans to either of these so that they would not default on their bonds. The subsidy consists of the following: the U.S. Treasury can lend up to $2.25 billion to Fannie Mae and Freddie Mac (investors probably assume an open-ended subsidy beyond the amount specified). Debt issued by these government-sponsored enterprises is eligible for use as collateral for public deposits, for unlimited investment by federally chartered banks and thrifts, and for purchase by the Federal Reserve in open market operations (that is, the Fed could buy these securities, just like it buys U.S. Treasury bills and notes, to expand the money and credit supplies). This latter provision of allowing the Federal Reserve to buy these securities is the other major part of the federal subsidy.

The CBO in May 1996 estimated that these various direct and indirect government subsidies to Fannie Mae, Freddie Mac, and the Federal Home Loan Bank Board (www.cbo.gov/dhowdoc.cfm?index=13&sequence=0) enabled them to cut the interest rates that they paid on their bonds by 25 - 60 basis points (a basis point is 1/100th of a percentage point), with an estimated midpoint value of almost 43 basis points, or 0.43 percentage point. Without this subsidy, the mortgage rate shown on Chart 2 at 6.00% might have been anywhere from 0.25 - 0.6 percentage points higher, or between 6.25 - 6.60%. Using the midpoint, that would raise the subsidy-removed rate on the 30-year fixed rate conventional mortgage to an estimate 6.43%. And because Fannie Mae and Freddie Mac are such massive players in the overall mortgage market, one can safely assume that the mortgage market (home buyers) receives a subsidy of about 0.43 percentage points.

After removing the subsidy given to the mortgage market, there is a major change in the spread between the rates charged on new car loans and mortgages and the respective default risk-free U.S. Treasury securities. The prevailing rate for a 36-month auto loan reported by bankrate.com was 5.75% on July 16, 2004. For a 48-month auto loan, the reported rate was 5.90%. (Note that these are for prime auto loans, the ones with the lowest risk of borrower default.) When compared to the U.S. Treasury yield curve, the 36-month auto loan had a spread of 2.76% (the yield on a 3-year note reported by the Federal Reserve Board was 2.99% on July 16, 2004) over the comparable maturity Treasury note; the 48-month auto loan had a spread of roughly 2.65% over what a Treasury security with 4 years remaining until maturity would have yielded (the Federal Reserve Board does not report a yield for a Treasury security with 4 years remaining until maturity - this estimate is based upon use of the yield curve line on the chart). Note that the 30-year fixed rate conventional mortgage is compared to the 10-year Treasury bond, which is a benchmark used by the financial sector to set rates on the 30-year mortgage. This spread is only 1.53% over the yield on the 10-year Treasury bond. But after removing the subsidy provided by the federal government, this spread widens to 1.96 percentage points above the 10-year Treasury bond yield. While this is still smaller than the spread on car loans over comparable maturity U.S. Treasury notes, one other major adjustment needs to be made to make the rates comparable, and that adjustment is for the risk of default.

The risk of default is priced into the interest rates charged on all non-federal securities (even state and municipal bonds have a default risk premium incorporated in the interest rates paid). What exactly is this default risk premium? Simply stated, it is an additional interest charge that takes account of the chances that a borrower will default on a loan, thus necessitating a potentially

costly repossession or foreclosure action. Repossession actions on the part of the vehicle title holder - the lender - are quite expensive and can sometimes require expensive detective services to track down the borrower and reclaim the vehicle. While a foreclosure on a mortgage may be more expensive dollar wise, as a percentage of the total value of the property in question, it could well be less than the comparable cost of a vehicle repossession. As a result, all the risks and expected costs of repossessions and foreclosures are factored into the interest rates charged on auto loans and home mortgages.

Getting estimates of the risk premium that is included in the interest rate charged on auto loans is now a much easier task given the advent of a huge market for auto loan-backed bonds. Bond rating firms regularly track loan losses. One recent study (June 2004), by Chris O'Connell of the Dominion Bond Rating Service (www.dbrs.com/web/sentry?COMP=2900&DocId=14441), provided estimates of the gross loss rate on auto loans that have been securitized and also the recovery rates on those loans. O'Connell did this for both prime auto loans and sub-prime auto loans, with sub-prime auto loans generally having a very high risk of default by borrowers. Using data from O'Connell's charts for three-year loans for the years 1998, 1999, and 2000 (the years for which complete 3-year repayment data were available), one could estimate cumulative gross losses on prime auto loans of an average of 2.24%. After taking account of a recovery rate of 37.5%, the net loss on such bonds would be 1.4% (or the 2.24% default risk multiplied by 1 minus the 37.5% recovery rate, or 2.24% multiplied by 0.625). This 1.4% net loss rate might well overstate the losses, depending upon how much of the value of the loan on repossessed vehicles was subsequently recovered.

In his analysis of the loan versus collateral value of an automobile over the course of hypothetical 48- and 72- month auto loans, O'Connell showed how the value of the car loan exceeded, by a significant margin, the value of the car because of rapid depreciation of a new car over its early life; that is, the wholesale value of a car falls more rapidly than the loan value does in the early part of the loan term. Only in the later stages of a car loan - if all principle and interest payments have been made on time - does the wholesale value of the vehicle finally exceed the loan value. If a loan is of a very short term and if the down payment is quite high (a 40-60 percent or higher down payment), then the wholesale value of a car would likely exceed the value of the loan. Otherwise, the loan holder has what is known as "negative equity" in the vehicle for much of the loan life. Therefore, a 1.4% default risk premium that is added into the interest rate charged on prime auto loans is not an unreasonable assumption, whether for the 36- or 48- month auto loan.

To estimate a prime auto loan interest rate from which the default risk premium has been eliminated, one would simply subtract the estimated net loan loss rate of 1.4% from the auto loan rates charged. For the 36-month auto loan rate of 5.75%, subtracting an estimated 1.4% default risk premium would result in an estimated default risk-free interest rate of about 4.35%. For the 48-month loan rate of 5.9%, subtracting the same 1.4% default risk premium would result in an estimated default risk-free interest rate of about 4.5%. These risk-adjusted (or risk removed) rates are shown on Chart 3 and compared to the default risk-free U.S. Treasury securities yield curve.

Let us now examine the 30-year fixed rate conventional mortgage loan and try to find out what kind of a default risk premium is included by lenders. According to the Mortgage Bankers Association of America (www.mbaa.org/news/2003/pr0620a.html), the actual foreclosure rate on prime conventional mortgages was 0.56 percentage points (or 56 basis points) in the first quarter of 2003. And this foreclosure rate does not represent the actual net loss rate by financial institutions on mortgage loans. Because of higher down payments ([illegible]0 percent minimum for a prime mortgage for which the borrower does not pay an additional amount for mortgage insurance) and the fact that homes do not depreciate as quickly (if at all) compared to automobiles, the 0.56% default risk premium is probably a very high estimate of the actual net losses on conventional prime mortgages. Subsequent auctions of foreclosed homes often yield proceeds that exceed the value of the loan.

In any case, let us use this estimated 0.56% as a loss rate on conventional mortgages. While that rate is not strictly comparable time-wise (meaning the time at which the respective estimates of default risk were estimated) with the 1.4% net default loss rate on prime new car loans, it is not an unreasonable number to use. Subtracting this 0.56% default risk premium from the 6.43% "unsubsidized" conventional mortgage rate gives an estimated 5.87% default risk-free mortgage rate.

As stated above, Chart 3 depicts the interest rates on auto loans and on the 30-year fixed rate conventional mortgage after all subsidies and default risks have been removed. Now they can be compared to each other and to comparable maturity U.S. Treasury securities. The 36 - and 48 - month auto loans, on a risk adjusted basis, had the following estimated spreads above Treasury yields: 1) for the 36 - month loan, the spread was 4.35% - 2.99%, or an estimated spread of 1.36%; 2) for the 48 - month loan, the spread was 4.50% - approximately 3.25%, or an estimated spread of about 1.25%. The 30-year fixed rate conventional mortgage, after removing the federal subsidy and the estimated default risk, had a spread of 5.87% - 4.47%, or about 1.4%. The similarities of these spreads indicate that after adjusting for risk of default, auto loan rates are no higher than mortgage rates.

Using the same subsidy and risk adjustment rates applied above for a longer time series of data shows (in Chart 4) that the risk-adjusted rates on auto loans (for the 36 - and 48 - month auto loans, which are generally below the rate on the conventional mortgage in the chart) has declined relative to the subsidy- and risk-adjusted rate on the 30-year conventional mortgage. While some of that move may be accounted for by the relative strength in the demand for housing, a significant part of this change had to do with recognition by investors that securitized auto loans offered an attractive risk-adjusted rate of return, even compared to mortgage-backed securities.

Additional evidence of the competitive nature of automobile loans comes from the interest rates charged by the finance subsidiaries of automobile manufacturers and banks as compared to the computed yield on a Treasury note or bond with 48 months remaining until maturity. Chart 5 shows this comparison. The highest rate on the chart is that charged by banks for a 48-month auto loan. Beneath that line, but closely tracking the yield on a 48-month Treasury note (which is generally the lowest line on the chart), is the rate charged by auto company financing

subsidiaries, as reported by the Federal Reserve Board. The significant difference between the cost of a car loan obtained at a bank versus a loan obtained from auto finance companies is that these subsidiaries of the automobile manufacturers have a policy of subsidizing interest rates on new car loans to stimulate sales. In effect, the auto companies are picking up the cost of defaults on auto loans - that is, not charging a risk premium on auto loans in order to increase sales.

But there is a limit to how much incentive financing auto manufacturers can offer. If there were no limit, banks and other financial institutions would not be competing profitably in the auto loan business.

The Bottom Line

Credit markets are much larger and more sophisticated than they were 30 or 40 years ago, and innovations in financial instruments and advances in information available on the quality and availability of credit have improved the economic efficiency of all credit markets, including the one for auto loans. What this means is that various loans reflect much more accurately the cost of credit. Loan markups - or spreads over the cost of funds, no longer can be excessive due to intense competition and the free flow of funds around the world in the search of the best possible yield. This also reflects the fact that lenders cannot get away with charging excessive interest rates to credit-worthy borrowers. To do so would be to chase away potential customers.

The estimates used in the above analysis strongly support the contention that banks, finance companies, or auto dealers do not charge interest rates that are excessive on prime auto loans when compared to the 30-year fixed rate mortgage after properly taking account of subsidies and risks. And note that when compared to U.S. Treasury securities, both auto loans and mortgage loans still have considerable risk, basically because the Federal Reserve, on a day to day basis, does not buy and sell either bonds securitized by auto loans or bonds securitized by mortgages. After accounting for all risks and subsidies, this as well as the massive size and breadth of the U.S. government security market explains the spreads between auto loans and mortgages and U.S. Treasury securities.

Sub-prime loans, whether in the area of auto loans or home mortgages, will always cost more since the risks of default are much higher than for loans to borrowers with superior credit ratings.

Thus, the economic evidence refutes the claims of those who state that auto dealers are charging excessive interest rates on loans.

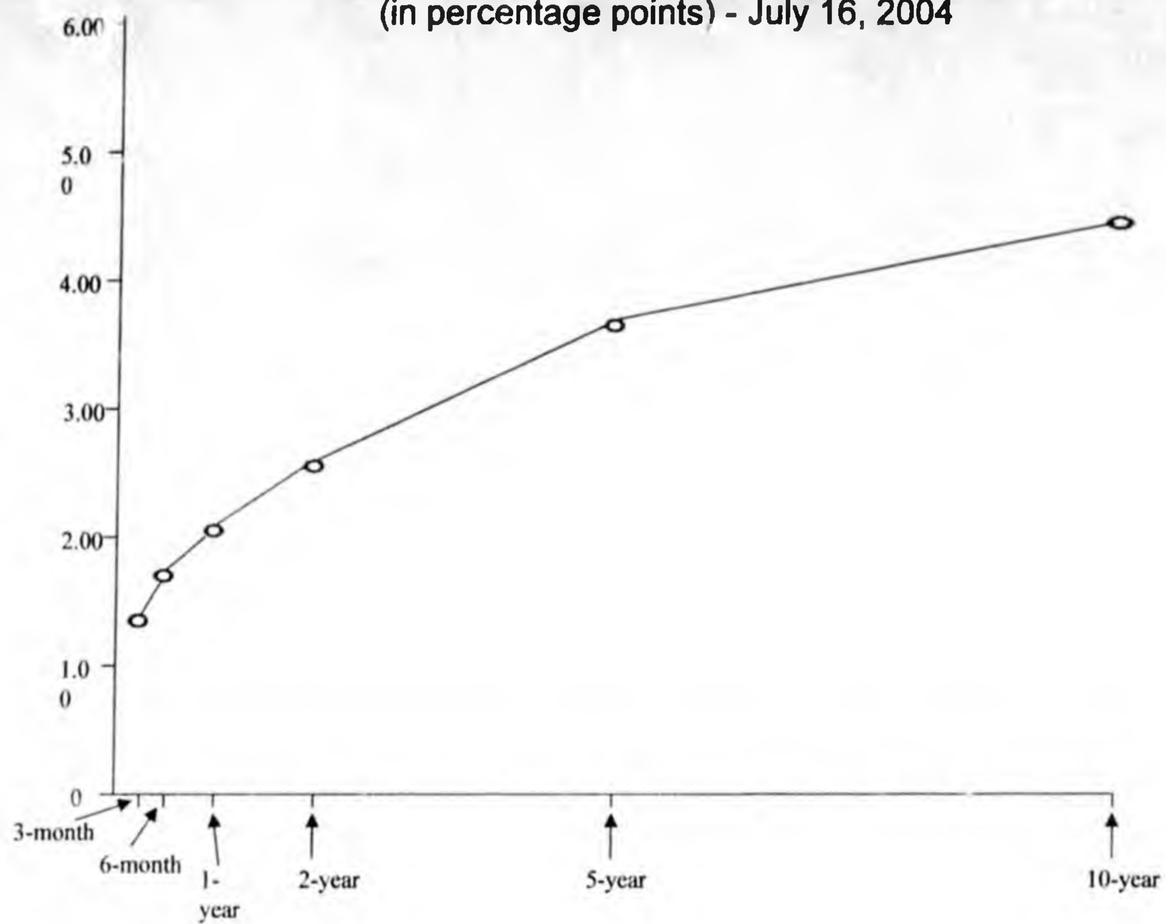


Chart 1 – US Treasury Securities Yield Curve
(in percentage points) - July 16, 2004
6.00
5.0
0
4.00
3.00
2.00
1.0
0
0
3-month
6-month
1-
year
2-year
5-year
10-year

Chart 2-Comparison of Interest Rates with Subsidy Removed vs Treasury security Yields - July 16, 2004-Note: 30-Yr Conventional mortgages are based on 10-Yr. Treasury Yields

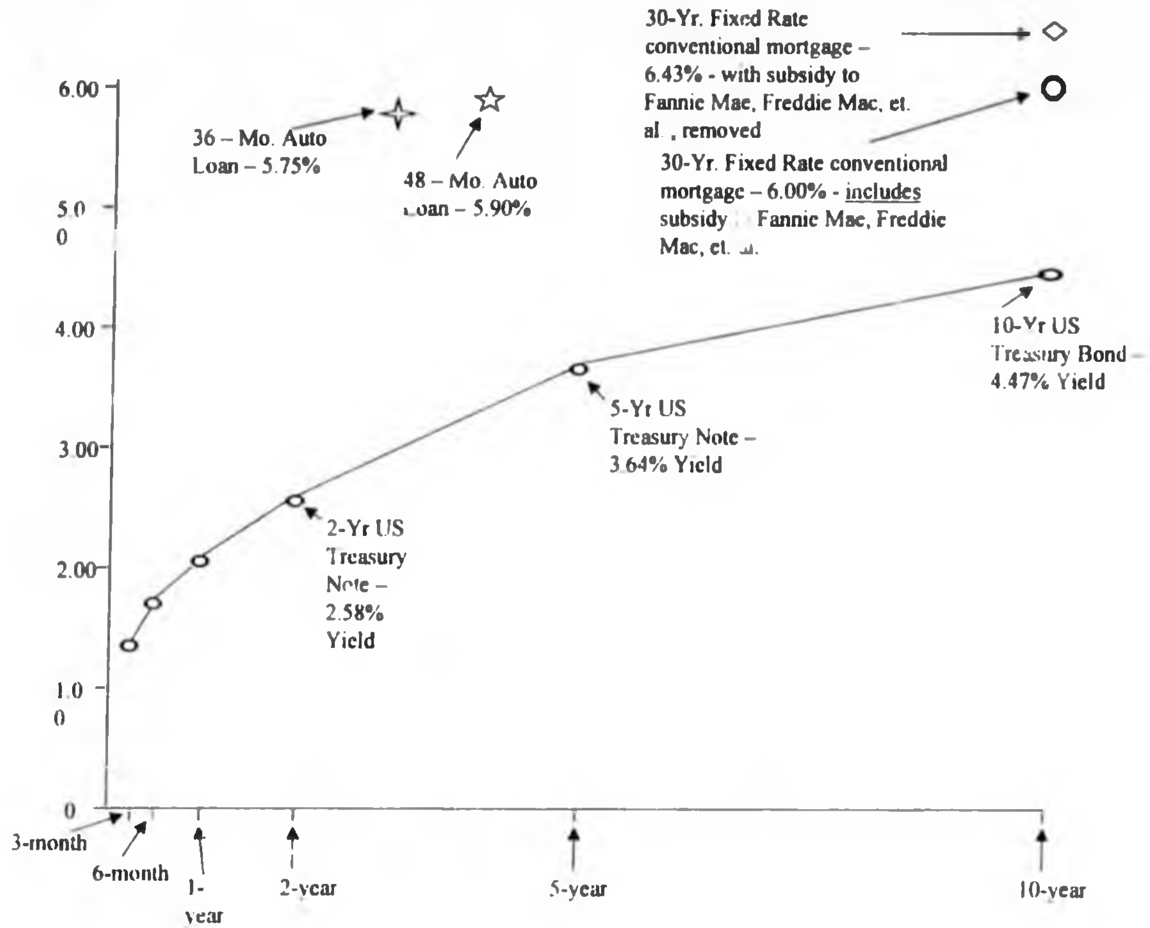
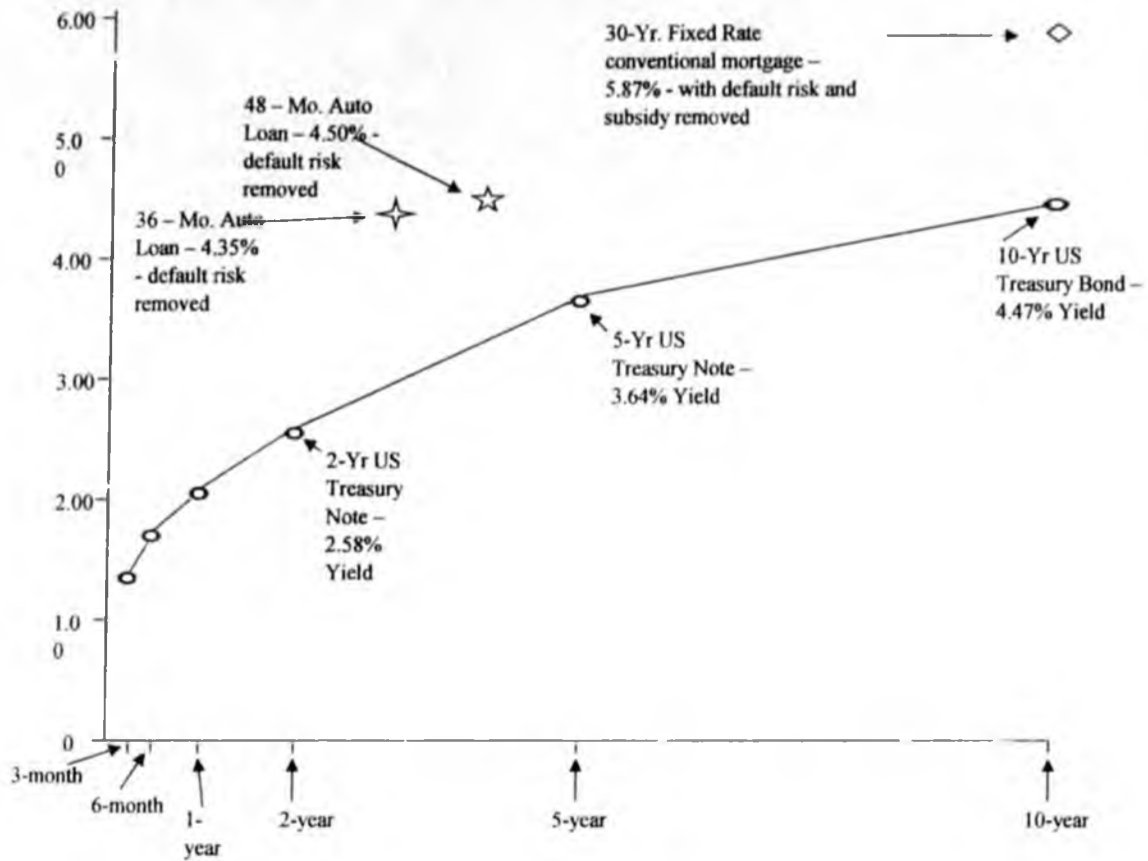


Chart 3-Comparison of Interest Rates – Default Risk and Subsidy Removed - July 16, 2004-Note: 30-Yr Conventional mortgages are based on 10-Yr. Treasury Yields



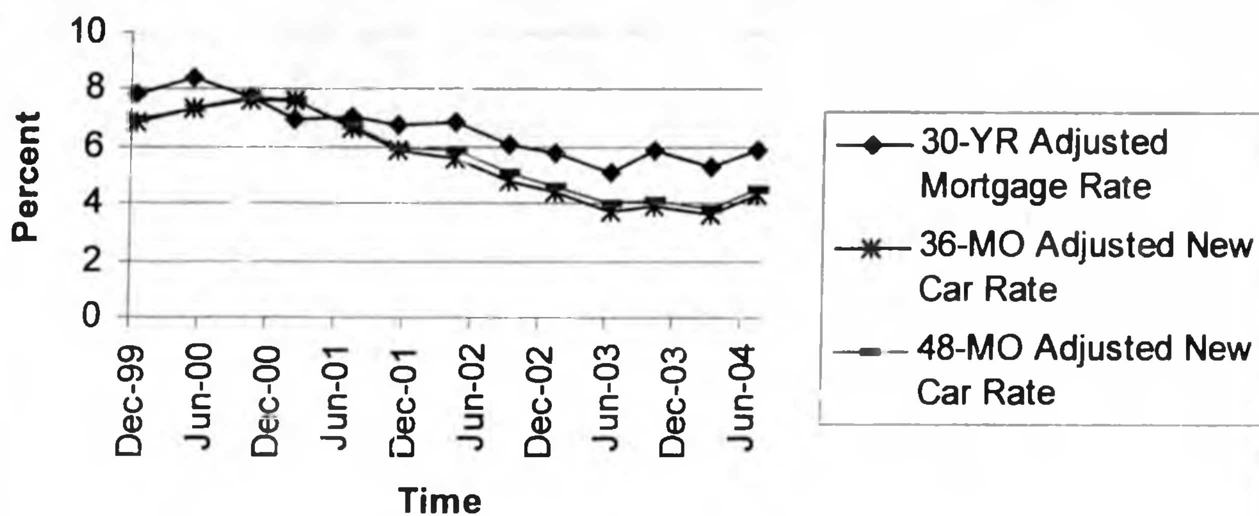


Chart 4 - 30-YR Adjusted Mortgage Rate vs 36- and 48- Month Adjusted Auto Loan Rates
10
8
6
4
2
0
Percent
Dec-99
Jun-00
Dec-00
Jun-01
Dec-01
Jun-02
Dec-02
Jun-03
Dec-03
Jun-04
Time
30-YR Adjusted Mortgage Rate
36-MO Adjusted New Car Rate
48-MO Adjusted New Car Rate

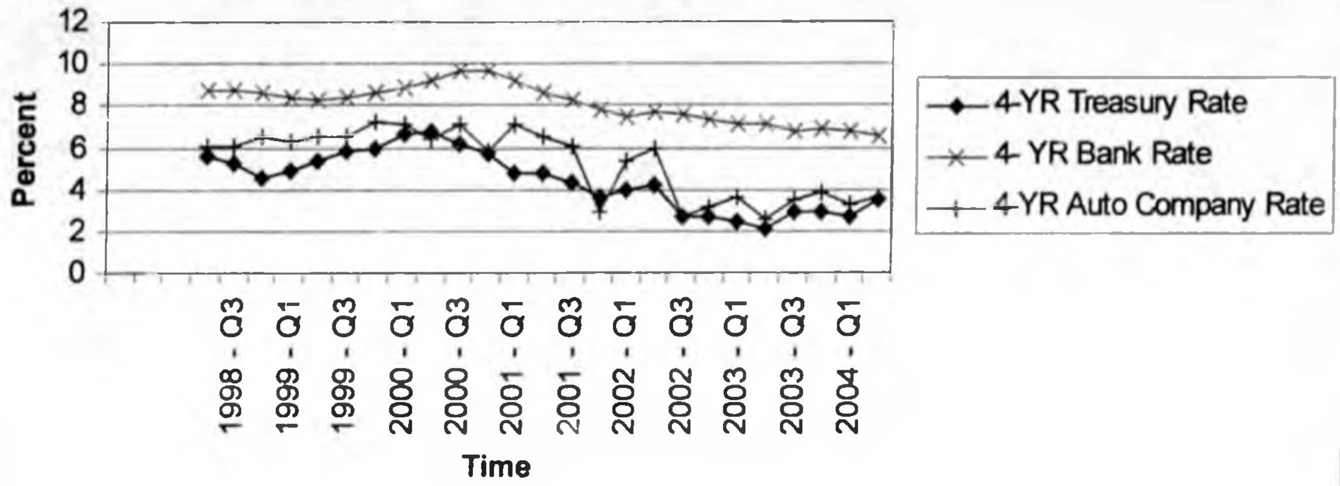


Chart 5 - Auto Loan Rates vs Comparable Treasury Note Yield
12
10
8
6
4
2
0
Percent
4-YR Treasury Rate
4- YR Bank Rate
4-YR Auto Company Rate
1998 - Q3
1999 - Q1
1999 - Q3
2000 - Q1
2000 - Q3
2001 - Q1
2001 - Q3
2002 - Q1
2002 - Q3
2003 - Q1
2003 - Q3
2004 - Q1
Time

COMPETITION IN AUTO FINANCING

By

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COMPETITION IN AUTO FINANCING
EXECUTIVE SUMMARY

What is the best way to determine whether consumers are likely to be treated fairly in a given marketplace? By examining how all the different players in the market interact with one another for the purpose of establishing, on a broad basis, whether that marketplace is competitive. This paper conducts such an analysis of the auto financing marketplace and finds it to be very competitive.

Section A. presents criteria for assessing what makes a marketplace competitive. Although few industries fit the requirements of perfect competition, economists and anti-trust experts agree that industries are reasonably competitive if their characteristics include numerous buyers and sellers who can make decisions independently; abundant, easy-to-obtain, understandable information; market-determined prices; few barriers to entry; and constant threat of potential competition from new products and market players.

Section B. explains that the auto financing marketplace satisfies all these criteria. There is a huge number of bank, credit union, and captive finance company competitors. There are few if any barriers to entry, and no player has the market power to set prices. A high level of clear information that almost every auto buyer can understand is available through dealer finance professionals, Truth in Lending disclosures, advertisements, and the Internet. And even after concluding a deal and beginning payments on a credit agreement, an auto buyer who finds a better opportunity is free to refinance, with no financial penalty.

Finally, section C. demonstrates how available market information provides additional support for the conclusion that the auto financing market in the United States is highly competitive. Excessively high interest rates for consumers are rare. Captive finance companies have lowered their maximum caps on dealer finance income to 300 basis points (bp) and in some cases 250 bp. Auto dealers generally maintain relationships with 5 to 10 or more financing sources and are able to offer financing rates that are comparable to, or better than, those offered directly by a credit union or a bank lender at a branch. Banks that provide indirect financing through dealers, an increasingly prominent force in this marketplace, generally provide wholesale or "buy" rates that allow a dealer to earn finance income and still match or beat the rates offered by the same banks directly to consumers for auto financing. If auto dealers were not competitive, they could not sustain their consistently high market share of total auto financing and credit unions would not have to work as hard as they do to compete with them.

COMPETITION IN AUTO FINANCING

Introduction

What is the best way to determine whether consumers are likely to be treated fairly in a given marketplace? By examining how all the different players in the market interact with one another for the purpose of establishing, on a broad basis, whether that marketplace is competitive. This paper conducts such an analysis of the auto financing marketplace and finds it to be very competitive. Section A. presents criteria for assessing what makes a marketplace competitive. Section B. then shows how the auto financing marketplace satisfies those criteria. And Section C. concludes by identifying how available market information supports this finding.

THE VEHICLE FINANCING MARKETPLACE IS VERY COMPETITIVE

A. Indicators of Competitiveness

In considering whether the auto financing marketplace is competitive, we begin by describing just what a competitive marketplace is.

Paul A. Samuelson, Professor of Economics Emeritus at MIT, and William D. Nordhaus Professor of Economics at Yale, in the famous textbook *Economics*, Fifteenth Edition, define perfect competition as a market condition in which no firm or consumer is large enough to affect the market price. They say such a situation arises where (1) the number of sellers and buyers is very large and (2) the products offered by sellers are homogeneous or indistinguishable. Under these conditions, each firm faces a horizontal, or perfectly elastic, demand curve.[1]

Imperfect competition is a condition in which perfect competition does not hold because at least one seller (or buyer) is large enough to affect the market price and therefore faces a downward-sloping demand curve (or supply curve). Common types of imperfect competition include monopoly and oligopoly. A monopoly is a market structure in which a commodity or product is supplied by a single firm. An oligopoly is a situation of imperfect competition in which an industry is dominated by a small number of suppliers.

Dennis W. Carlton, Professor of Economics at the University of Chicago Business School, and Jeffrey M. Perloff, Professor of Agricultural and Resource Economics at the University of California at Berkeley, in *Modern Industrial Organization* note that perfect competition provides a benchmark against which the behavior of markets is judged, even though perfect competition rarely, if ever, is encountered in the real world. Their criteria for perfect competition are the following:

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[1] Samuelson, Paul A. and William D. Nordhaus, *Economics*, New York: McGraw Hill, Inc., 1995, pp 129-143.

- *Perfect information*. Buyers and sellers each know the price and quality of the product.
- *Market determination of price*. Buyers and sellers each take the price at which the product can be purchased or sold as given. Price is determined by the market and no buyer or seller can influence it. Using the market entails no transaction costs.
- *Many buyers and sellers*. There are many potential or actual buyers and sellers who can enter and exit the market in the long run.
- *Perfect divisibility of output*. The amount of output demanded or supplied varies continuously with price. This assumption avoids problems caused by large discrete changes in either supply or demand in response to small price changes.[2]

Professors Carlton and Perloff observe that even though few industries fit the requirements of perfect competition, economists often speak of certain types of industries as being reasonably competitive if their characteristics include independent price setting, many firms, and free entry and exit.

Phillip E. Areeda, late Professor of Law, Harvard University; Herbert Hovenkamp, Professor of Law, University of Iowa; and John L. Solow, Associate Professor of Economics, University of Iowa, in a widely used, 20-volume text and reference book, *Antitrust Law*, are consistent with the economists cited above in their slightly more detailed description of perfect competition. Their criteria are as follows:

- Sellers and buyers are so numerous that no individual's output or purchasing decision has any perceptible impact on output or price.
- Each seller and buyer makes decisions independently, without agreement or influence from others.
- All productive resources are freely mobile among markets; there are no barriers to entry or exit.
- All sellers and buyers have sufficient knowledge of all production techniques, input costs, prices, and other relevant market facts.
- Producers make input-output decisions solely to maximize return on capital — that is, they seek minimum-cost production techniques and net-revenue-maximizing levels of output.
- There are no "externalities." Producers pay all social costs incurred in the production of goods and services and receive payment for all social benefits conferred.[3]

In a less-than-competitive market, such as a monopoly or oligopoly, sellers have "market power," or the ability to raise prices without losing sales. According to Professors Areeda, Hovemkamp, and Solow, a firm is potentially in violation of antitrust law if it can profitably set prices well above its costs and it enjoys some protection against a rival's entry that would erode such supracompetitive prices and profits.

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[2] Carlton, Dennis W. and Jeffrey M. Perloff, *Modern Industrial Organization*, Glenview, IL: Scott Foresman/Little, Brown Higher Education, 1990. p66.

[3] Areeda, Phillip, Herbert Hovenkamp and John L. Solow, *Antitrust Law: An Analysis of Antitrust Principles and Their Application*, New York: Aspen Law & Business, 2002, Volume IIA, p 4.

The purpose of market definition in antitrust is not an end in itself, argue Robert G. Harris, Professor of Business Administration, University of California, Berkeley and Thomas M. Jorde, Profesor of Law, Boalt Hall School of Law, University of Califorma, Berkeley. They explain that the purpose of defining a market is to help measure a firm's power over price and output, or its power to foreclose markets. If it were possible to prove such power directly, definition of the relevant market would not be necessary. Theoretically, at least, market power could be proved solely by evidence of predatory conduct, excessive profits, price-cost margins, price discrimination, and elasticities of supply and demand. However, Professors Harris and Jorde note that practical problems of acquiring and presenting proof of these alternative indicators of market power have caused litigants and courts alike generally to abandon such efforts. Instead the courts have adopted a market structure method of analysis. First, the court defined a relevant market in terms of product and geographic space. The court then measures individual firm shares and industry concentration levels in that market.[4]

In assessing market power, Ira Horowitz, Professor of Business, University of Florida, explains that the courts are concerned with several factors, most notably market share, the number and relative size of firms in the market, conditions of entry, both actual competition in the market and potential competition from firms outside the market, and whether a trend toward concentration exists. Entry conditions and potential competition relate to the ease with which prospective sellers can enter the market. All of these factors are influenced by how the market is defined. Horowitz notes that market definition, market power, and product definition are inseparable. Market definition is based on numerous factors such as product definition (including product characteristics and interchangeability) and geography (i.e., area of effective competition), and therefore must be based partly on judgment. Professor Horowitz points to the need for a systematic and objective procedure for market definition to minimize bias toward any party or group.[5]

A competitive marketplace can be defined from a business-strategy standpoint as well. According to a well known model developed by Michael Porter of the Harvard Business School, there are five forces that influence a firm's competitive strategy:

1. Bargaining power of customers
2. Bargaining power of suppliers
3. Threat of new entrants
4. Threat of substitute products
5. Intensity of competitive rivalry, as evidenced by factors such as:
    a. large number of firms
    b. slow market growth
    c. low switching costs
    d. low levels of product differentiation[6]

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[4] Harris, Robert G. and Thomas M. Jorde, "Antitrust Market Definition: An Integrated Approach," *California Law Review*, January 1984.

[5] Horowitz, Ira, "Market Definition, Market Power, and Potential Competition," *Quarterly Review of Economics and Bnsiness*, Autumn 1982, pp 23-42.

[6] Porter, Michel E., *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, New York: The Free Press, 1980.

Although Porter built his model primarily to help corporations develop competitive strategies, that model also can be used to assess the competitiveness of a market. If all five forces are in play, the market must be competitive.[7]

Based on the foregoing analyses of a competitive marketplace, this study uses the following criteria to define the market for auto financing and assess its competitiveness:

1. Number of buyers and sellers; number of consumer choices
2. Bargaining power of customers and suppliers
3. Nature of products – commodity vs. specialized
4. Level of information available on alternative choices
5. Market determination of price
6. Consumer's ease in understanding, shopping, and choosing among alternatives
7. Market power of competitors
    a. Market concentration
    b. Market shares of competitors
    c. Competitors' power over price
    d. Competitors' power to exclude other competitors
    e. The ability of one firm or a few firms to raise prices above competitive levels and restrict the entry of competitors
8. Threat of potential competition
    a. New products
    b. Easily substituted products
    c. Competitors from different geographic markets
    d. New categories of market players
9. Barriers to entry[8]

B. How the Vehicle Financing Marketplace Satisfies the Criteria for Competitiveness

Applying the foregoing criteria, we conclude that the vehicle financing marketplace is very competitive, as explained below.

Number of buyers and sellers; number of consumer choices

Auto financing is a market of many buyers and sellers. Among the sellers, there are many competitors with well distributed market shares, including both dealers and financial institutions.

> *Auto dealers* - There are currently approximately 21,650 new car dealerships in the United States. Virtually all of those dealers assist customers in obtaining financing, and most of them deal with 5 to 10 lenders so as to have alternative choices to suit a wide range of consumers.

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[7] Also, force number five, the intensity of competitive rivalry, is a function of forces one through four: bargaining power of customers, bargaining power of suppliers, threat of new entrants, and threat of substitute products.
[8] Alpert, Geraldine, "Is Market Structure Proof of Market Power?" *Mergers & Acquisitions*, Summer 1984. Ms. Alpert notes that if a market is not protected by entry barriers, no seller has long-run market power.

Auto manufacturers' captive finance companies - All the major brands, international and domestic, have captive finance companies that provide auto financing through dealers.

Banks - As of 2002, there were 7,887 banks in the United States.[9] A large portion of bank auto financing is done indirectly through dealers. Indirect financing banks compete for the business of auto dealers. Indirect financing banks also lend directly to consumers, but mainly as an accommodation to customers with established relationships.

Credit unions - A total of 9,542 credit unions belong to the Credit Union National Association (CUNA), and about 85 million Americans belong to credit unions. Of these, a total of 9,014 credit unions, covering more than 83 million members, are chartered and supervised by the National Credit Union Administration and insured by the National Credit Union Share Insurance Fund. Mike Schenk, Vice President, Economics & Statistics at CUNA, notes that credit unions are formidable competitors because they offer two advantages over the manufacturers' captive credit arms: a lower cost of funds because they do not pay federal income taxes, and the ability to offer members a full range of financial services.

As of June 2004, new auto loans comprised 16.9% and used auto loans 21.1% of total credit union loans, which were $403.3 billion. More importantly, credit unions had 17.9% of the overall auto financing market at that time, according to Callahan & Associates.

Credit unions have had a significant, though fluctuating, share of this market for decades. An August 1984 article in *Credit Union Magazine* noted that credit unions in recent years had been holding about 20% of the auto financing market.[10] But then a June 1986 article in the same magazine reported the credit union market share of auto financing had slipped to 11.5%. The article made several suggestions on how credit unions could restore their historic market share, such as providing pre-approved credit for an amount rather than for a specific car, making the application process quicker and easier, offering "balloon note" financing as an option, and providing leasing arrangements, which were down significantly from the share achieved several years prior to that time. The author recommended that these services be supported by a strong marketing program.[11] The credit union community has been engaged to this day in strong marketing efforts to increase its share of auto financing, as discussed further in a later section of this paper.

Credit unions also are becoming increasingly active in indirect financing. In the first six months of 2003, credit unions granted more than $12 billion in indirect credit — about 10% of all credit union financing made during that period. That represented a 26% increase over indirect financing volume in the first half of 2002, according to Callahan & Associates.[12] Similarly, in 1993, 4% of credit unions had indirect financing arrangements

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[9] U.S Department of Commerce *Statistical Abstracts – 2003*.
[10] "Some New Twists in Auto Lending," *Credit Union Magazine*, August 1984, p10.
[11] Condon, Mark, "Auto Loans: Boost Your Market Share," *Credit Union Magazine*, November 1986, p 46.
[12] Harris, Donna, "Credit Unions to Court Dealers at NADA Bash," *Automotive News*, October 27, 2003, p 30.

with dealers, according to figures from CUNA. By 2002, 15% of credit unions — mostly large ones — representing 42% of credit union members had indirect financing arrangements.

Internet providers – The market share of web-based auto financing sources, though still relatively low, is growing. CapitalOne, the largest Internet auto credit provider, has about $7 billion in auto receivables, more than half of which have been generated through direct channels such as the Internet.[13] One reason the Internet lenders' market share remains relatively low is that those lenders provide less personal service than dealers provide — an important consideration given the complexity of an auto financing transaction.

Perhaps more important than the market share of web-based lenders is the way the Internet helps consumers do their homework before visiting dealer showrooms and helps them become more savvy.[14] Information available for car buyers over the Internet is discussed in a later section of this paper.

On-line lenders are forcing credit unions, as well as dealers and banks, to develop their own on-line services. Bankrate.com estimated in May 2002 that 3,100 of 10,710 credit unions have websites.[15] Members of nationwide credit unions for a long time have been accustomed to banking remotely. For example, web-based services have been particularly important for the Navy Federal Credit Union and other military credit unions because of the mobility of their members.

Commercial banks are entering the on-line vehicle financing space as well. In 1999, Bank of America swapped its 80% ownership in auto lender CarFinance.com for a 5% stake in E-Loan, which planned to operate CarFinance.com as a subsidiary. The bank's purpose for investing in an e-commerce subsidiary was to learn how the business works.[16]

Bargaining power of customers and suppliers

As explained elsewhere in this paper, consumers have the ability to compare auto loan alternatives from numerous sources. At the same time, the proliferation of lenders restricts their ability to raise rates at will; hence, they do not have substantial bargaining power.

Nature of product

As a product, auto financing is almost a pure commodity. There is very little variation in fundamental terms among the major auto finance companies' credit agreements. Competition is

[13] *Hoover's Company Profiles*, November 3, 2004.
[14] McElhinny, Brad "Autos On-line: Websites Allow Customers to Shop from Home." *Charleston Gazette*, October 4, 2004, p 1D.
[15] Forster, Stacy, "Credit Unions Get Competitive in Online Banking," *Wall Street Journal*, May 15, 2002, pD@.
[16] Dalton, Gregory, "Bank Swaps Stakes in Web Lenders, *Information Week*, August 30, 1999, p28.

based primarily on interest rate and maturity, although level of service and convenience and finding the finance source best suited to the buyer also are important factors.

Level of information

A high level of information on auto buying and financing is available from numerous sources. There is extensive advertising in newspapers, magazines, television, and radio. Information is also readily available on the Internet. A search for auto financing alternatives on the Internet is easy, and it provides lots of useful information. An auto buyer who simply uses a search term such as "auto loan" or "car loan" with a widely used search engine such as Google will find thousands of websites with the more useful loan and related service providers appearing early on the list. Those websites quote rates, provide calculators to help the buyer determine affordability, provide other helpful information on buying and financing a car, and in some cases accept applications for financing online.

According to data from J.D. Power & Associates, 60% of auto purchasers went on-line for information in 2002.[17] J.D. Power also reports that 80% of auto shoppers use the Internet, and Forrester Research estimates that the shoppers send 1.8 million requests to dealers through their websites each month. According to the NADA *Industry Analytics Quarterly Survey*, 93% of dealers have interactive websites, two-thirds of which allow buyers to submit credit applications over the Internet. Forrester says that 5% of all Internet searches are related to research for a car purchase. Auto sites are receiving an incredible 60 million hits a month.[18] A study by Wirthlin Worldwide commissioned by Automotive Retailing Today, an industry consortium, reported that 50% of 887 consumers interviewed, all of whom had purchased or leased a car in the past 18 months, used the Internet to research their car purchases, 32% used it to compare prices, and 26% used it to research financing alternatives. Seventy-one percent of respondents visited more than one dealership when looking for a car, while 23% visited more than one dealership to find information on auto financing.

Market determination of price

The price of auto financing is determined by a large competitive market of numerous finance sources from which the consumer, either acting independently or working with an auto dealer, can choose.

Consumer's ease in understanding, shopping, and choosing among alternatives

If not all consumers, at least a significant majority of them can be expected to have the ability to understand the abundant available information on auto financing alternatives and to be comfortable working with it.

To begin, auto financing advertisements and websites are easy to understand. The Truth in Lending Act (1968) requires Annual Percentage Rate (APR) disclosure to facilitate consumer

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[17] Senecal, Denise and Bill Mertka, "Listen to Your Members: Two Ways to Boost Your Credit Union's Auto Volume," July 14, 2003, www.creditunions.com.
[18] Conrad, Christine, "Web Woos Car Buyers," November 1, 2004, www.creditunions.com.

understanding. APR is a summary measure of the price of credit to make comparison shopping easier. Federal regulators have spent years "branding" APR as the primary tool for comparison shopping for credit, and those efforts have paid tremendous dividends in terms of consumer financial awareness.

Further, consumers themselves report that they have sufficient information to make informed decisions. In the Wirthlin study for Automotive Retailing Today, 87% of non-minority and 78% of minority respondents who recently had purchased a car said that the salesperson gave them enough information to make an educated and informed purchase decision. Ninety percent of non-minority and 78% of minority respondents said that dealer finance specialists gave them enough information to make educated and informed financing decisions.

What's more, the following statistics from the *2003 Statistical Abstract of the United States*, published by the U.S. Department of Commerce, provide some indirect evidence of the financial and computer literacy of the U.S. population as a whole:

- 84.1% of the U.S. population had a high school diploma and 26.7% have a college degree.
- Out of a total of 109.3 million households in the United States, 74.4 million are owner-occupied; 44.6% of U.S. families have home-secured debt, which includes first and second mortgages and home equity loans.
- 60 million households in the US have personal computers and 50.7 million have access to the Internet.
- 53.5% of employed people in the U.S. use computers in their work.[19]

Market power of competitors

Because of the large number of dealers, no single dealer has a commanding market share with the ability to set prices in most markets. Reflecting historical trends and state franchising laws, auto retailing is highly fragmented. Although there is a long-term trend toward consolidation, with fewer dealers selling more cars each year, 93% of the market is still represented by privately owned dealers.[20] Thus, the dealership market is not concentrated.

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[19] To be sure, some consumers are not at ease with the mathematics and technicalities of auto financing and need extra explanation. In particular, younger, first-time buyers sometimes need guidance when approaching credit markets. Credit-challenged shoppers often are focused on finding a dealer that will approve financing. For them, the monthly payment is a key concern. In these cases, the dealers' approach generally is to understand the person's situation as fully as possible, to explore vehicle alternatives that might be affordable, and to search for all possible credit sources, including financial institutions with an appetite for sub-prime credits.

However, the fact that some consumers may have difficulty navigating the system does not affect its competitiveness. As explained in the text, the fact remains that the majority of shoppers can understand and handle the process easily. And it is this feature that evidences the degree of competition present. In other words, the less able vicariously benefit from the facility with which the majority can operate.

[20] Casesa, John A. and John J. Murphy, *The Integrated Business Model of Franchised Auto Dealers*, Merrill Lynch, Global Securities Research & Economics Group, April 19, 2004, p4.

The same can be said of captive finance companies, banks, and credit unions. Numerous large banks and credit unions compete on a regional or nationwide basis as indirect lenders. The number of captive finance companies is far smaller, but a recent sample of AutoCount market share figures indicates that no individual captive generally accounts for more than about 12-13% of a given geographic market, that the market shares of other finance sources drop off sharply, and that the total number of lenders in a state is in the thousands.[21] Because of the large number of players, both auto dealers and finance companies, that interact and compete with each other and set their prices independently, competitive pressure allows little opportunity for any player or group of players to achieve pricing power, to form cartels, to collude, or to exclude competitors.

Threat of potential competition

The auto financing industry is continually subject to the threat of new entrants and the threat of substitute products. Auto dealers face constant competition from other dealers in their markets, and financing is one of the factors on which dealers compete. One dealer may put together a better assortment of finance sources than another does, and may be more skillful in picking out the financing package best suited to a particular consumer. In offering a given financing package to a consumer, a dealer is always aware of potential competition from different kinds of financial institutions such as banks and credit unions from different geographic areas as well as Internet lenders. Large banks, many large credit unions, and Internet lenders have no geographic boundaries. Commercial banks offer not only traditional secured auto loans but also auto financing through home equity loans, which has grown in popularity in recent years.

Barriers to entry

There are no significant barriers to entry for either auto dealers that extend credit through their finance departments or financial institutions that buy the credit contracts. Although auto manufacturers assign non-exclusive territories to dealers through franchises and some of those franchises are long established, there still are opportunities for someone who wants to enter the dealership business. There are no restrictions on entry of dealers into the used car business. Similarly, even though it is consolidating, banking remains a crowded business, and new community banks are opening continually to challenge the allegedly less personal service of large regional and nationwide banks. There are no significant barriers to prevent the establishment of a new credit union or Internet loan provider, or to prevent any bank from competing in the financing business in any geographic region. As already mentioned, Internet providers and many large credit unions operate nationwide without any geographic barriers. A 1998 change in law helped the growth of credit unions by expanding the definition of "community," thereby liberalizing credit unions' criteria for accepting new members.

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[21] In Florida during the month of May 2004, for example, 118,117 auto loans were made by 3,624 lenders. The top 200 lenders made 101,878 loans, accounting for 86.3% of the volume. Within the top 200, the market share of 20 captives was 33.9%, 53 banks 26.3%, and 51 credit unions 16.6%. The top six lenders were SunTrust with 6,754 loans (5.72% market share), GMAC with 6,739 loans (5.71%), DaimlerChrysler Financial Services with 4,723 loans (4.00%), American Honda Finance with 4,645 loans (3.93%), Nissan Infiniti Financial Services with 2,911 loans (2.46%), and Bank of America with 2,590 loans (2.19%).

Refinancing option

The existing system of vehicle financing offers one additional feature that virtually no other market has and that contributes mightily to the system's level of competitiveness. This feature is the penalty-free refinance option. Even after entering into a financing agreement and starting to make payments, a consumer can refinance with no pre-payment fee. Very few products carry such a liberal return policy or one that lasts throughout the entirety of the buyer's ownership period.

One reason why a consumer might refinance is because interest rates have declined since the time the financing agreement was written. Credit unions promote refinancing options to members, particularly in the type of declining interest rate market that we saw during the past several years. In fact, there were hundreds of thousands of auto refinancings each year during that period. In September 2003, CNW Marketing Research, Inc., an Oregon firm that provides consumer spending data for automakers and other consumer product companies, estimated that the number of auto refinancings would climb to 565,000 by the end of 2003, up from about 468,000 in 2002 and less than 300,000 in 2001.[22]

Dealers are also aware that a customer who finds better terms for reasons other than declining interest rates — such as a financing rate as originally extended that was above the going market-competitive rate — can refinance as well. Every time a refinancing occurs, any unearned finance charge is lost, thereby wasting much of the dealer finance department's efforts in extending the financing. But, if the refinancing occurs because the buyer concludes that the dealer overcharged for the credit, the dealer will lose much more. In that situation, not only will the dealer lose its profits from the deal, but the dealer's reputation and ability to retain the confidence and loyalty of the customer (and his or her family and friends) for future transactions also will be compromised if not entirely destroyed. This market reality is well known to dealers, disciplines their behavior, and drives them to charge market-competitive rates.[23]

Conclusion

Auto financing fits the definition of a highly competitive marketplace. There is a huge number of competitors from various types of financing institutions and there are no barriers to prevent the entry of new competitors. No single competitor or group of competitors has pricing or exclusionary power. There is abundant, easily accessed information on alternative financing choices. Through advertising, websites, Truth in Lending disclosures, and the efforts of dealer finance people and financial institutions, the mathematics and technicalities of auto financing are explained in terms that almost every potential buyer can understand. And even after concluding a deal and beginning payments on a credit agreement, an auto buyer who finds a better opportunity is free to refinance, with no financial penalty.

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[22] Kim, Jane J., "Don't Overlook Auto Refinancings," *The Wall Street Journal*, September 10, 2003, pD2.

[23] It is significant in this regard that, while there exists a very real refinance market, one does not see significant amounts of advertising by lenders to refinance the auto financing extended by dealers. If there was widespread overcharging by dealers, those lenders could earn a healthy profit by refinancing the over-charged credit and would actively solicit them from consumers. The absence of such marketing efforts suggests that competitive forces are working, and that dealers are charging market-competitive rates.

C. Existing Market Information Confirms that the Auto Financing Market is Competitive

Available market information provides additional support for the conclusion that the auto financing market in the U.S. is highly competitive.

Dealer finance income is not excessive; it runs well below even the limited rate caps set by finance sources

Excessively high interest rates for consumers appear to be rare today. Captive finance companies have lowered their caps on dealer finance income in recent years. By 2003, three percentage points (or 300 basis points (bp)) had become the industry-standard cap, and some major finance sources recently lowered their caps to 250 bp.[24] Furthermore, market forces have resulted in dealer finance income that is generally well below these caps and even lower in the case of special- or subvened-rate financing.

The retail financing rates offered by dealers are competitive

For the reasons that follow, the retail auto financing rates offered by an auto dealer are generally comparable to, or better than, those offered directly to consumers by a credit union or a bank lender at a branch. Indirect auto financing — making auto financing available through dealers — is a huge business for large banks such as Bank of America, BB&T, JP Morgan Chase, Wachovia, and Wells Fargo. Those banks focus their marketing efforts on dealer relationships. They compete to have their offerings among the alternatives that dealer finance people consider when shopping car financing alternatives for their customers. Bank relationship managers coordinate all the services their banks can sell to dealers.

David Stevens, Senior Vice President, Wachovia Bank, says that his bank's volume of indirect auto financing through dealers is significantly higher than its volume of direct auto loans to consumers. Similarly, according to Pete Davenport, Executive Vice President, Sales & Finance Department of BB&T Corporation, his bank's auto financing portfolio is 90% indirect and 10% direct. He thinks it would be reasonable to conclude that other large banks in the indirect financing business would have a similar portfolio breakdown.

For banks that choose to be in the indirect auto financing business, dealers are a far more important channel for auto financing than the same banks' branch systems. That is partly because those banks' indirect lending channels and systems, including automated financing approval and servicing, are more efficient for auto financing than their branch systems are. While acknowledging that he cannot generalize beyond a certain point, Mr. Stevens of Wachovia believes that any bank with a dealer financial services group such as Wachovia's would originate the great majority of its automobile financing in such a group. It would be difficult for a bank to originate auto financing through a branch structure at anywhere near the same cost as that of a dealer financial services group with an operations center dedicated entirely to auto financing that

[24] For example, GMAC has recently announced a 250 bp dealer finance income cap on financing up to five years and 200 bp for financing longer than five years.

processes hundreds of thousands of auto finance transactions at any given time. Indeed, wholesale or "buy" rates that banks offer to dealers for indirect auto financing generally allow a dealer to add finance income of 50 to100 bp, and often even 200 bp, and still quote a lower rate than the consumer would find for direct auto financing offered by the same bank. This is confirmed by a recent comparison of buy-rate sheets sent by indirect auto financing banks and retail auto financing rates offered by the same banks in the same geographic areas through their branches, as quoted in the *Greenbook Lender's Guide* and the *Roberts Report*.[25] The rates quoted in these reference books were assumed to be the best rates available for creditworthy customers and therefore were compared with the best rates on the buy-rate sheets.

Dealers could not sustain a high market share if they were not competitive

Dealers could not achieve and retain a high market share of auto financing, competing with banks, credit unions, and Internet providers, if they were not competitive. Dealers we interviewed finance 55% to 90% of the cars they sell, with most in the 60% to 70% range. A sample of data from AutoCount taken for North Carolina and Florida the month of May from 2000 to 2004 shows both the amount of competition in the auto financing business and the consistent market shares maintained by dealers. (AutoCount captures every auto financing in 42 states based on department of motor vehicle data.) In each of the months sampled, more than 2,500 different parties in North Carolina and more than 3,000 parties in Florida provided auto financing. Among the top 200 lenders for the sampled months for each state, the market share of captives' financing provided through dealers ranged from 34% to 38% for Florida and 21% to 3[illegible]% for North Carolina. The market share among the top 200 lenders of commercial banks that provided more than 100 loans in the sampled months, and therefore were assumed to be providing indirect auto financing through dealers, ranged from 25% to 29% for Florida and 26% to 36% for North Carolina.

These market share figures do not take into account cars that are financed with home equity loans. For auto dealer and DMV purposes, cars financed through home equity loans are considered to be financed with cash.

Direct lenders opt to compete with auto dealers on criteria other than price

Numerous articles in credit union trade magazines on marketing auto loans indicate the challenges credit unions face in competing with auto dealers. While these challenges may stem partly from incentive financing provided by auto manufacturers and to the convenience of one-stop shopping at the dealership, they are also attributable to a significant degree to credit pricing. In fact, when promoting direct auto loans to consumers, credit unions recognize they often cannot compete based on interest rate and therefore emphasize other credit union advantages such as the total relationship benefits they provide to their members. Similarly, many credit unions recognize that they have lost their financing opportunity once the consumer is in the

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[25] The *Greenbook Lender's Guide*, published by Reid Communications, Inc., Elgin, Illinois, is a monthly reference book that lists various auto lenders' rates and terms for a given state, arranged alphabetically by city and lender. It is sold state-by-state on a subscription basis. *The Roberts Report*, published monthly by The Roberts Report, Phoenix, Arizona, provides similar information as well as other reference information useful to auto buyers, also on a subscription basis.

dealership, and therefore offer financing as part of comprehensive auto buying services, attempting to capture the customer as early in the buying cycle as possible. Furthermore, credit unions, like banks, promote the use of tax-deductible home equity loans for auto purchases as a basis upon which to compete with auto dealer financing.

Examples of credit union marketing programs that focus on differentiators other than price include the following:

- Patelco Credit Union (San Francisco, California) works with Esurance, a direct-to-consumer personal auto insurance provider, to provide one-stop shopping for both auto insurance and auto loans.[26]
- American Airlines Employees Federal Credit Union (Dallas, Texas), with 193,000 members, has a comprehensive member education program called CAARS that provides budgeting advice and information on car safety and reliability issues.
- Digital Federal Credit Union (Maynard, Massachusetts) has a member education program called StreetWise that covers subjects such as safety recalls, seat belt problems, and health insurance evaluations. Digital FCU's on-line services are used by 89,000 of its 168,000 members.[27]
- Atlantic Credit Union (Newtown Square, Pennsylvania) increased its auto loans in 2001 when overall auto lending was down by placing itself earlier in the buying cycle and changing its focus from auto financing to auto buying. The credit union knew it could not compete with subvened rates and lost all hope of getting a loan once a member was in the dealership, so it restructured its marketing efforts and integrated all of its auto services into one car-buying service, including discount purchasing, pre-approved financing with credit sales or leases, extended warranty coverage, and Carfax used car reports. Regular contact with members was considered an essential element of this marketing reorientation.[28]
- An article in *Credit Union Magazine* notes that a relatively small percentage of credit unions offer leasing or balloon auto loans, and that credit unions could increase their auto financing market share by offering those alternatives.[29]
- Recognizing that it could not match subvened rates and realizing it would need to find creative ways to add value, Baxter Credit Union developed an "auto equity loan" that ties the car to a lien on the member's house. Arkansas Federal Credit Union uses an adjustable-rate auto loan to bring interest rates down to levels approaching those of the captives.[30]
- An article in *Credit Union Management* argues that credit unions are at little risk of losing members to cyber-lenders if they offer their own on-line lending options. Credit unions that connect car-shopping members with auto-buying services, reference sites, and options to purchase insurance along with on-line auto loans are building member loyalty through one-stop shopping.[31]

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[26] "Esurance is One-Stop Shop for Auto Loans, Insurance." *Best's Review*, November 2001, p133.
[27] Sutton, Remar, "A Mission of Member Service," *Credit Union Magazine*, July 2001, p36.
[28] Zenker, Gary, "Time Out!" *Credit Union Management*, December 2001, p20.
[29] Mink, Mary, "Leasing Could Bolster Credit Union Auto Loans." *Credit Union Magazine*, p17.
[30] Merrick, Bill, "Shifting Auto Loans Out of Reverse," *Credit Union Magazine*, May 1999, p48.
[31] Bankston, Karen, "Riding the Wave," *Credit Union Management*, September 1999, 46.

- University Federal Credit Union (Austin, Texas), with 100,000 members, has a four-person, full-time staff dedicated to finding members who have financed autos elsewhere and booking "recapture" or "second chance" auto loans.[32]

Indeed, recent credit union marketing strategies reveal that they are not able to compete fully with dealers. Increasingly, credit unions are not marketing against auto dealers, but rather joining them. Credit unions, particularly the largest ones, are doing a growing amount of indirect financing with auto dealers. According to figures from CUNA, in 1993, 4% of credit unions had indirect financing arrangements with dealers. By 2002, 15% of credit unions representing 42% of credit union members had indirect financing arrangements. Callahan & Associates reported in August 2003 that in the second quarter of 2003, the more than 900 credit unions participating in its "First Look" program produced a 3.98% increase in auto loans; auto loans at the 10 largest credit unions participating in that program experienced a 33.9% increase. Much of that growth was attributed to indirect financing; 9 of those top 10 engage in indirect financing. Almost half of the loans generated by those credit unions were loans arranged at dealerships.

Dealers have incentives to be competitive

Dealers have important incentives to offer competitive auto financing rates. A dealer can lose a car sale to another dealer that offers better financing terms. When the dealer does sell the car and provide financing, if it fails to provide a customer with a competitive rate, the customer is likely to realize that in short order and refinance with someone else. Furthermore, dealers that do not satisfy customers or treat them poorly are likely to be subjected to harsh criticism in web-based owners' "forums" or "chat rooms." Auto dealers place huge values on their reputations in their communities.

Dealers have other competitive attributes as well

Among the other competitive attributes of auto dealers are access to multiple financing sources, convenient hours of operation, ability to handle all of a customer's financing and insurance needs, and volume buying power. Dealers we interviewed cite relationships with from 5 to 10 or more finance sources, each of which sends rate sheets on a regular basis. Mr. Stevens of Wachovia notes that his bank's dealer customers, numbering more than 3,000, tend to have relationships with captives, two or three banks, and one or more providers with an appetite for paper that is riskier than normal. Dealers try to manage their relationships so that they do not send any finance source paper it is likely to turn down.

Auto sales and finance employees are available during evenings and weekends, when banks are closed. This is particularly appealing to people who are not able to visit a dealership during their own normal weekday working hours. Dealers have the ability, through well trained finance personnel, to handle all aspects of a transaction, including the purchase, financing, insurance, and the service contract. Finally, dealers can get improved wholesale buy rates through volume buying power with finance sources.

[32] Sutton, Remar, "Give Members a Second Chance," *Credit Union Magazine*, July 2002, p29.

Conclusion

Market information on dealer finance income and dealer market share of auto financing provides further evidence that the marketplace is competitive. Dealer finance income is not excessive; it is capped at 2.5% to 3% by the major finance sources and generally runs well below that level. Wholesale or "buy" rates offered by indirect financing banks give dealers the latitude to offer auto buyers better rates, even including the dealer finance income, than they could arrange at branches of the same banks. Auto dealers' high market share of total auto financing agreements shows how competitive those dealers are, and credit unions attest that dealers are tough competition. At the same time, the significant market shares of credit unions and other direct lenders show that the consumer has choices and that the marketplace as a whole is competitive.

AMENDMENT #2

OFFERED IN THE HOUSE BY:

TO: CSHB 383 (Draft Version "S")

Page 2, lines 23-29

Delete all material.

Insert:

"(f) In addition to the other requirements of this section, if a motor vehicle dealer arranges financing for a proposed buyer, the dealer must disclose in writing, and before the sale is finalized:

(1) whether the interest rate quoted to the proposed buyer is different than the interest rate charged to the dealer, and

(2) the interest rate quoted to the buyer may not be the lowest interest rate available."

3rd

AMENDMENT

OFFERED IN THE HOUSE BY: Kapsner

TO: CSHB 383 (Draft Version "S")

Page 2, lines 23-29

Delete all material.

Insert:

"(f) In addition to the other requirements of this section, if a motor vehicle dealer arranges financing for a proposed buyer, the dealer must disclose in writing, and before the sale is finalized:

(1) whether the interest rate quoted to the proposed buyer is different than the interest rate charged to the dealer, and

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