

CFSI Center for Financial Services Innovation
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**Innovations in Auto Finance:
Profitable Opportunities that Benefit
the Underserved**

Underbanked Forum
June 2, 2008

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Cars: Critical for Work and Family

A critical means of access and choice:

- Jobs (88% of Americans drive to work)¹
- Services (health care, day care, schools)
- Affordable housing, food, merchandise

Car ownership is pervasive:²

- 86% of families own at least one vehicle
- 90%+ when head of household works
- 70% among bottom quartile of household net worth



1 Blumenberg, Evelyn and Margy Waller. "The Long Journey to Work: A Federal Transportation Policy for Working Families." The Brookings Institution Series on Transportation Reform. Center on Urban & Metropolitan Policy, July 2003. Cited in Sandra Gustitus, Melody Simmons, and Margy Waller. "Access to Driving and License Suspension Policies for the Twenty-First Century Economy." The Mobility Agenda, June 2006.

2 Federal Reserve Bank, 2007 Survey of Consumer Finances.

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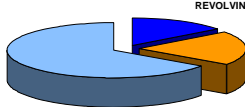
An Asset and a Liability

A significant part of household assets.

But 18% of average household expenditures...¹

- Owns 2.0 vehicles
- Spends \$8,351 annually on vehicle purchases, gas, maintenance, repairs, insurance, and finance charges (\$2,497 for last two)

...and a significant portion of total household debt:²



1 US Bureau of Labor Statistics, 2005 Data Cited in Statistical Abstract of the United States; insurance cost estimate based on 2 vehicles at \$913 annual cost per insured vehicle.

2 Federal Reserve Board of Governors 2006 Data

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CFSi Center for Financial Services Innovation **Car Loans Are Widespread**

40% of families have an outstanding car loan or lease¹

- Nearly 50% among families with heads <35 years old
- Nearly 50% among families with heads who are employed
- 30 – 35% among those in bottom quartile of net worth

Most consumer car purchases are financed:²

- 92% of new car purchases
- 73% of used car purchases

1 2007 Survey of Consumer Finances; includes 34.9% with vehicle installment loans; 5.2% with vehicle leases
2 CFSi estimate based on 2004 data

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CFSi Center for Financial Services Innovation **A Financial 'Rite of Passage'**

Buying a first car is a financial milestone:

- An objective for savings
- Part of the leap to full-time work
- If financed, part of a credit history

But first time buyers are the most disadvantaged

- Lack credit history
- Lack car buying experience
- Have least equity



Wanted: Financial innovations that...

- Increase chances of obtaining reliable, affordable transportation
- Result in positive equity and credit history
- Leverage relationships with financial services providers
- Are profitable

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CFSi Center for Financial Services Innovation **Role of the Dealer**

FDIC MoneySmart: *"Buying a Car Step 1: Shop around for auto financing before going to the dealer. Get pre-approved for a loan."*

But over 75% of car loans are obtained at the dealer.

- "What monthly payment can you afford?"

CONSUMER AUTO LOANS & LEASES BY ORIGINATION CHANNEL ¹		
NEW CARS (12.4M Units = 100%)	USED CARS (24.6M Units = 100%)	
13%	30%	"DIRECT"
87%	55% -- FRANCHISED DEALERS	"INDIRECT"
	15% -- INDEPENDENT DEALERS	

Finance and insurance is important to dealer profits

- >40% of profits of franchised dealers
- >20% of profits of independent dealers

1 CFSi estimates based on 2004 data

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CFSi Center for Financial Services Innovation **Car Ownership Challenges**

Potential pitfalls in used car purchases & ownership :

- Dealer overpricing
- Cost and availability of financing
- Buying a lemon
- Maintenance and repairs costs

The underserved face greatest risks, lasting consequences

- Financing expensive (3 –10X Prime APR) for buyers w poor/thin credit
- Buy-Here/Pay-Here dealers serve the most troubled borrowers
 - Do not report to the credit bureaus
 - APRs are 25%+ (35%+ is common)
 - Repo rates are often 50% or more
- Cars in poor condition can leave buyers in debt AND choosing between expensive repairs or doing without transportation

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CFSi Center for Financial Services Innovation **Special Challenges for Underbanked**

Loans are expensive for poor credits and thin credits

- 42% of underbanked are unscorable (thin or no files)¹
- 2/3rds of underbanked under 25 are unscorable¹

COMPARATIVE MONTHLY PAYMENTS: \$10,000 USED CAR LOAN over 48 Months			
Prime	Near Prime	Sub-Prime	Buy-Here/ Pay-Here
7.5%	12%	18.9%	26+%
\$241	\$263	296	\$337

Cost of auto insurance may be double for poor or thin credits

1 CFSi 2008 Underbanked Consumer Study

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CFSi Center for Financial Services Innovation **Three Types of Innovations**

1. Using better tools for assessing lender risk
 - Loans using alternative credit data and scores
2. Reducing or transferring default risk from lenders
 - Loan repayment via payroll deduction
 - Lenders' insurance
3. Migrating borrowers to direct loans
 - Car purchasing services offered by banks & credit unions
 - Loan refinancing services

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CFSi Center for Financial Services Innovation **Risk Assessment Tools**

Example: PRBC (Microbilt) and Desert Schools FCU Thin File Loans


- Bill and rental payment history supplements existing trade lines
- Minimum 3 trade lines for six months; no bads (thin file only)
- Interest tied to number and length of trades, capped at 12%
- Results: beginning August of '07 – all loans paid as agreed
- In testing at Enterprise Rent-A-Car sales lots

Drawbacks:

- Manual verification of bill & rental payments requires 24 – 48 hours

Other alternative credit data scores with auto loan tests:

- Lexis/Nexis
- eBureau
- L2C
- FICO (Expansion Score)



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CFSi Center for Financial Services Innovation **Reducing or Transferring Risk**


Payroll deduction: US military's allotment system (deducts bill payments prior to payroll deposit) has been used to offer affordable no-credit loans

Example: "Starter loans" offered direct by military banks & credit unions (e.g. Eisenhower Bank, Air Force FCU)

- Direct loans for bank, CU customers with direct deposit
- Interest rates up to 12.5 percent
- Maximum loans from \$15,000 - \$25,000
- Renegotiable after "seasoning"

Example: MILES (Military Installment Loan and Education Service)

- Indirect loan program offered thru 500+ dealers for military personnel by Dealer Financial Services, Inc.
- 18.5% interest up to 42 months for E1 – E3 pay grades
- Loans purchased by US Bank



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CFSi Center for Financial Services Innovation **Reducing or Transferring Risk**

Loan insurance: insurer charges an up front premium and/or captures part of interest spread in return for assuming default risk

- Growing in popularity for applicants with prior credit problems

Example: CUNA Mutual Lenders Protection™

- 170 participating credit unions
- Premium paid up front by lender
- Covers 80% of vehicle value at time of default
- FICO scores as low as 600 (lower, until recently)
- Interest rates up to 18 percent (per Federal CU cap)*
- Available through CUDL, other indirect origination systems.



*May be higher for state-chartered credit unions.

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CFSi Central Finance Services Institute **Migrating Buyers to Direct Loans**

Advantages for consumer:

- Negotiate over car and price, not monthly payment
- Loan application time is best chance for budgeting for car ownership
- Rate is likely to be lower than dealer offer (excluding mfr. incentives)

Advantages for lender:

- Direct loans default at lower rates
- Bank, CU, Money Services can use "insider" info to better assess risk
 - E.g. payroll deposits, monthly bill payment patters
- Expands "share of wallet," loyalty, and relationship profitability

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CFSi Central Finance Services Institute **Migrating Buyers to Direct Loans**

Car buying services at FI web sites: best of both worlds?

- Provides instant gratification of dealer with access to special deals
- Retains "filter" of applying for direct loan first



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CFSi Central Finance Services Institute **Migrating Buyers to Direct Loans**

Refinancing Example: Rate Genius

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CFSI Center for Financial Services Innovation **Conclusions, Questions**

Will depositories take back loan share ceded to indirect lenders?

- Lower default rates
- On-line and mobile banking as new origination points
- Ability to use internal information (e.g. DDA deposit and bill payment information) to assess risk.

Recommended Resource: William Myers: "Steer Clear: How Credit Unions Help Car Buyers Avoid Predatory Loans;" National Credit Union Foundation and Annie E. Casey Foundation, 2008.
<http://www.aecf.org/KnowledgeCenter/Publications.aspx?pubguid={92D021A8-6C0F-44C0-887E-871661875D5B}>

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