Expensive Loans to the Poor and Unemployed: The Subprime Specter Returns, High Finance and the Growth of High-Risk Consumer Debt

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With more than half of American consumers classified as having subprime credit scores,1 it is no surprise that subprime lending is once again on the rise. Making expensive loans to the underemployed and overextended may help fuel economic growth2; however, it is neither just nor sustainable. Dependence on higher-risk subprime loans to boost spending seems to be a symptom of larger problems––low wages and income volatility.

With nearly all Americans, other than the ultra-wealthy living paycheck to paycheck,3 families have too little savings, if any, to cushion downturns.4 It is a paradox. Taking on more debt becomes necessary to afford essentials (such as a reliable car to drive to work), and increased private sector spending supports job creation, yet heavy debt coupled with unreliable income puts consumers and thus society at greater risk of insolvency. Even if the lenders themselves can charge high enough rates to make up for the delinquencies and defaults without failing, most families cannot avoid painful losses should they fall behind. Making subprime loans less predatory and more affordable (and thus less likely to cause defaults) is only one part of the solution.

Unlike the toxic home loans that led to the 2008 global financial crisis, the recent return of subprime is not in residential mortgages, but instead in auto, credit card, and personal loans. Approximately 40 percent of these types of loans that were made in 2014 were subprime.5 This time is not so different, however. The pressure to make loans regardless of a borrower’s ability to pay is all too familiar.6 Given the attractive price that banks, private equity firms,7 and other financial institutions can pay for higher-yielding subprime loans, lenders who interact with consumers have incentives to engage in predatory, abusive, risky, and sometimes unlawful behavior to produce them. Of notable concern is the increasing investor appetite for bonds backed by pools of subprime auto loans.8 This demand drives volume, and the quest for volume may be pushing loan originators deeper into the credit pool, encouraging fraudulent auto loan applications, and fostering other questionable underwriting practices and loan structures.

Fortunately, as advocates and the media shine light on these and other shady activities, industry is showing discipline, and federal and state regulators are taking action. Perhaps these steps can help avert unnecessary suffering and systemic risk while preserving access to fairly priced credit for low- and middle-income Americans. Meanwhile, arguably, higher wages and greater government spending for higher education and health care (which would lower business and household costs) would better strengthen the economy than continued dependence on maxed-out consumers.

The Troubled History of Subprime Lending

Subprime consumer loans are those made to borrowers with credit scores below 640 (or 660, according to some lenders' guidelines) out of 850. Law scholars Teresa Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook characterized subprime lending in their 2000 book, The Fragile Middle Class: Americans in Debt, as "granting credit specifically to people who are living on the edge." The authors explained that the "large new niche in the credit business" was "one much applauded on Wall Street" because it paid "such high returns that big profits still remain even after the defaults and bankruptcies are subtracted."9

Their words were prescient. As we witnessed in the run-up to the mortgage crisis, lenders bundled risky (often subprime) loans, transforming them assembly-line style into securities that were resold to investors. Selling riskier home mortgages to Wall Street earned loan originators more income than the traditional thirty-year, fixed-rate mortgage would.10 As law scholars Kathleen Engel and Patricia McCoy documented in their 2011 book, The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps, the subprime lending market started out as a "pocket of the U.S. home loan market" but later "mutated like a virus into a crisis of global proportions." Motivated by outsized profits, "the various actors in the subprime food chain [became] ever more brazen and, with each passing year, subprime crowded out safe, prime loans, putting homeowners at risk of losing their homes and ultimately pushing the entire world economy to the edge of the cliff."11

As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank),12 many of the predatory yet profitable residential mortgage-lending practices that were often associated with subprime credit have been banned.13 In addition, under Dodd-Frank, a new federal agency, the Consumer Financial Protection Bureau (CFPB) was created with unified authority over many areas of consumer finance and the power to create new regulations. For example, the CFPB now forbids the payment of home mortgage "steering" incentives.14 Steering involved paying mortgage brokers bonuses for putting borrowers into higher-risk, higher-cost loans than they qualified for. In addition, the CFPB's Ability-to-Repay Rule mandates that, generally, creditors make a "reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability to repay the [residential mortgage] loan according to its terms."15 Among the eight factors that must be considered is the full monthly payment, not just an initial teaser or partial-payment rate.16

The Return of Subprime Lending

The promise of big profits from subprime lending––at least in the short run––is just as enticing today. With regulations tighter on home mortgages, investors are seeking other subprime opportunities. Whereas in 2007, subprime comprised 20 percent of home mortgage loans originated, it accounts for less than 1 percent today.17 As noted above, in 2014, it accounted for more than 40 percent of non-residential consumer loans made. As the Wall Street Journal reported in June 2014, "At a time when many other revenue engines are sputtering, subprime borrowers are especially attractive to banks because they tend to pay higher interest rates and generate more revenue as long as they don't stop making their minimum required payments."18

Subprime loans can also benefit consumers, to the extent they are offered at fair rates, and they actually have the means to pay them back. These loans also boost certain sectors of the economy, as they facilitate the purchase of vehicles and other consumer goods and services. Without access to this type of credit, consumers might resort to even more expensive, and sometimes dangerous, fringe sources of funding such as exploitative payday loans19 or illegal loan sharks. As Benjamin Lawsky, superintendent of the New York State Department of Financial Services, explained, “We don’t want to totally disrupt the market [and] create a problem where people can’t get credit.”20 Similarly, economics professor Lawrence White acknowledged that although “not all subprime loans are inappropriate . . . no lender should put a borrower into a loan he or she can ill-afford.”21 And therein lies the problem. Given current incentives, and borrower profiles, some lenders appear to be doing just that.

Investigative journalists, academics, advocates, and even industry insiders have been uncovering problems in consumer subprime markets. Michael Corkery and Jessica Silver-Greenberg of the New York Times recently reported the story of an unemployed woman on food stamps who was given a loan of more than $30,000 at an 11.89 percent interest rate to purchase a BMW and had not made any of her payments. She said she thought she was just co-signing for her daughter and also indicated that she had informed the dealership employee that she did not have a job.22 After conducting personal interviews with borrowers, attorneys, and credit analysts, and scouring court records, the reporters concluded that, “some of the companies, which package and sell the loans, are increasingly enabling people at the extreme financial margins to obtain loans to buy cars.”23

Economics professor Amir Sufi has expressed concern about vulnerable consumers. “Subprime borrowers, who pay much higher interest rates on loans than customers with good credit scores, are more prone to missing payments in periods of economic distress.”24 Sufi and economics professor Atif Mian, who coauthored House of Debt: How They (and You) Caused the Great Recession, and How We Can Prevent It from Happening Again, have documented the relationship between the build-up of household debt and the financial crisis.25 In a 2014 blog post, they expressed concern and provided evidence that “the only way the U.S. economy can generate significant consumer spending is through aggressive lending to borrowers with low credit scores.”26

Also concerned are some industry experts. A former Wells Fargo executive offered words of caution in an American Banker op-ed: “I predict two bad outcomes as a result. A new wave of consumers will become overextended, default on their loans and further damage their credit. And the new non-bank lenders,” including Silicon Valley start-ups, who have helped drive the increase in subprime lending are in for an unpleasant surprise. . . . As new entrants in a highly competitive market, they are likely subject to “adverse selection.” They’ll take on riskier customers in order to build their business.27

The rise in subprime consumer debt coincides with the growth of total non-housingrelated household debt. Whereas aggregate housing-related debt (including mortgages and home equity lines of credit) peaked in late 2008 at $9.99 trillion and now stands at $8.68 trillion, non-housing household debt (which includes student, auto, credit card, and personal loans) has climbed higher over the years. In 2008, the total non-housing household debt was $2.71 trillion, but by the first quarter of 2015, it was up to $3.17 trillion. The largest portion is student loan balances ($1.19 trillion), with auto loan balances ($968 billion), and credit card loan balances ($684 billion) next in line.28 Each of these types of consumer debt are also often bundled and transformed into asset-backed securities.29

A Boom in Auto Loans

Presently, there is about $968 billion in auto loans outstanding.30 Of this balance, roughly 20 percent is from subprime or “deep subprime” loans (those with credit scores in the three hundred to five hundred range).31 According to data from Experian, in 2014, subprime borrowers with very low credit scores, on average, paid
12.72 percent interest on their auto loans. In contrast, borrowers with the highest scores paid
2.63 percent, and on average, all borrowers paid 4.47 percent.32 Subprime auto loans are also structured to reduce monthly payments by stretching out obligation over a longer period of time, sometimes seven years. Like higher interest rates, longer terms impact a borrower’s ability to pay.33

Lenders are more attracted to auto loans rather than other types of consumer subprime loans because they are backed by collateral. The car can be repossessed upon default. In contrast, often credit card and personal loans are unsecured. Of course, with low down payments and lengthy terms, the repossessed car may be worth less than the amount owed. According to Corkery and Silver-Greenberg, Americans are so dependent on their cars that investors are betting that they would rather lose their home to foreclosure than their car to repossession. Or in the words of a Santander Consumer investor, “You can sleep in your car, but you can’t drive your house to work.”34

However, they noted that this truism is starting to lose its validity with rising delinquencies. In addition, car repossession rates are rising. According to Chris Kukla of the Center for Responsible Lending, “Between the second quarter of [2013] and the second quarter of [2014], Experian has reported a 70 percent increase in the repossession rate.”35

The subprime auto loan boom coincides with the remarkable growth in new auto sales. As Sufi and Mian observe, “The financial system was lending against homes before the Great Recession, and now it has moved to lending against cars. But the basic message is the same.” That message, in their words, is that, “It appears that the key to boosting spending in the U.S. economy is subprime lending.”36 The ninety plus day delinquency rate was at 3.5 percent at the end of 2014 up from 3.1 percent from the previous quarter, but an improvement from the end of 2010, when it was at 5.3 percent. And, it was down to 3.3 percent by the end of the first quarter of 2015. Subprime loans have helped to boost auto sales year after year.37 Overall, new car loans are higher in 2014 than they were in 2007. Subprime auto lending is now back to the same level as in 2007, with roughly $130 billion originated in 2014.38

These subprime auto loans are pooled together into conduits that issue securities backed by the monthly payments. These subprime auto asset-backed securities (ABS) are reminiscent of subprime mortgage-backed securities. Attorney John Van Alst of the National Consumer Law Center said, “We’ve seen a lot of Wall Street money chasing these loans.”39 Institutional investors that purchase subprime auto asset-backed securities include mutual funds, hedge funds, pension funds, and insurance firms. As the New York Times reported, in September 2014, Santander led an offering that was in such high demand, they had to increase it by 35 percent to $1.35 billion. The securities issued had yields double that of some U.S. Treasuries, yet were rated just as safe.40 According to the Federal Reserve Bank of New York, securitizations of subprime auto loans in the second quarter of 2014 were double the amount of four years earlier.41

Aware of looser lending standards, higher delinquency and repossession rates, some lenders are cutting back. In a move demonstrating a desire to contain potential losses, as of March

2015, Wells Fargo was "limiting the dollar volume of its subprime auto originations to 10 percent of its overall auto loan originations, which last year totaled $29.9 billion."42 Most of these loans are made indirectly through dealerships. As a result of this cap, the bank was turning down loans some dealers would have expected to be approved. Indeed, more prudential lending by the largest banks has led to lower default rates overall.43 Although this might result in safer loans, it is quite possible that even if other big lenders follow Wells Fargo's lead, smaller banks and new non-bank entrants to this market may scoop up these riskier loans. Data do suggest an increase in riskier loans entering these pools. According to figures from Citigroup, about 73 percent of auto loans that are securitized have terms of greater than five years.44

There are other concerns that echo the premortgage-crisis abuses that appear in subprime auto lending that have come to the attention of consumer advocates and regulators. The Center for Responsible Lending (CRL) released a report in 2011 highlighting how hidden dealer markups on auto loan interest rates greatly impact subprime borrowers. The markup of an auto loan is sometimes 2 percent above what the lender informed the dealer that the customer would qualify for. Yet, according to CRL, there has been no legal obligation to disclose the markup to consumers.45

These dealer markups are similar to the bonuses or "yield-spread premiums" paid to mortgage brokers to steer borrowers into more expensive loans. Dealer markups impact many people as about 80 percent of car buyers finance their purchase with a lender indirectly through the dealership instead of directly obtaining a loan from a bank or credit union. The CRL report was based on industry sources as well as an "analysis of automobile asset-backed securities [and] data from twenty-five auto finance companies representing combined 1.7 million accounts at yearend 2009." On average, auto loans were marked up $714. Used car loans were higher than average at a markup of $780, with new car loans marked up about $494.46 According to Chris Kukla of CRL, "People who bought a car in 2009 paid $25.8 billion in interest over the lives of their loans associated with dealer markup."47 In addition, dealer markups have been part of allegations of racial discrimination in auto lending and associated legal settlements.48 CRL recommends banning discretionary dealer markups and permitting transparent flat-rate fees.49

In addition, there is increasing evidence of misrepresentations and possibly fraud on auto loan applications. Both federal and state government officials have begun investigating investigating allegedly fraudulent practices within the subprime auto lending industry. According to at least one account, this includes an investigation into "whether dealerships have been inflating borrowers' income or falsifying employment information on loan applications to ensure that any borrower, even some who are unemployed and have virtually no source of income, can buy a car."50 The Department of Justice has also begun investigating lenders for whether there were racial disparities in how auto loans were offered.51

Also, the Federal Trade Commission (FTC) is continuing to keep an eye on subprime auto loans. In recent years, the FTC "has cracked down on a group of dealerships found to be misrepresenting customers' monthly payments. Other cases have addressed dealerships that allowed customers to trade in cars on which they still owed money, requiring them to pay off their old car and their new car at the same time."52 Dodd-Frank generally exempts auto dealers from CFPB jurisdiction. However, the agency is permitted to supervise many other participants in the auto lending market. This includes banks with assets of more than $10 billion that either directly lend to consumers or purchase installment contracts from dealers. The CFPB has power to supervise, regulate, and bring enforcement actions against these large bank lenders. Smaller banks must follow regulations but are not subject to CFPB supervision or enforcement.53 The CFPB is like other federal and state authorities, concerned about dealer markups as part of discrimination in auto lending in violation of the Equal Credit Opportunity Act. It has sent civil investigative demands and warnings to lenders and other participants involved in auto loans.54

Very recent developments show promise. In June 2015, the CFPB issued a rule that allows the agency to supervise large non-bank auto lenders. According to the CFPB, this group of non-bank lenders accounts for about "90 percent of non-bank auto loans and leases, and in 2013 provided financing to approximately 6.8 million consumers."55 In addition, in July 2015, Honda Finance Corporation settled with the Department of Justice and the CFPB related to violations of the Equal Credit Opportunity Act. A two-year long investigation of Honda revealed that unfair lending practices including discretionary dealer markups resulted in higher interest rates paid by African-American, Hispanic, Asian, and Pacific Islander borrowers than non-Hispanic white borrowers. Honda paid $24 million into a fund for affected borrowers (who on average paid $150 to $250 more on their loans) and agreed to cap the dealer markup at 1.25 percent above the buy rate for loans with terms of five years or less.56

Subprime Credit Card and Personal Loans

Subprime credit card lending is also growing.57 Like auto and home loans, subprime credit card debt is also resold and transformed into securities. And, recently, there has been a return of securitization of subprime personal loans, a practice that had been rare since the 1990s.58 In 2014, there was more than $21 billion in new subprime credit card loans.59 In 2014, the Wall Street Journal reported based on data from Equifax that "Banks and other lenders issued 3.7 million credit cards to so-called subprime borrowers during the first quarter, a 39 percent jump from a year earlier and the most since 2008."60 In early 2014, one-third of Capital One's credit card balances were with customers who had subprime or no credit scores. At JPMorgan Chase, more than 16 percent of credit card balances were owed by borrowers with subprime scores. A spokesperson for the bank indicated that borrowers were better positioned to manage credit-card debt than previously.61

One of the abuses associated with subprime credit cards includes "fee harvesting." Fee harvesting involves offering a card with a very low credit limit but with very high upfront fees that are immediately charged to the card, becoming part of the consumer's balance and leaving an even smaller amount of credit remaining available.62 According to a National Consumer Law Center report, in some cases, consumers were offered credit cards with a $250 limit. However, much of this was eaten up by various fees, reducing the available credit to just $72.63 The CFPB is concerned about fee harvesting and has taken action against lenders in violation of the Credit Card Accountability Responsibility and Disclosure (CARD) Act of 2009.64 This law limited up-front fees to no more than 25 percent of the available credit limit.

Lenders, including non-banks, are offering personal loans at very high interest rates. For example, online lender Elevate reportedly charges between 36 percent and 365 percent on loans to borrowers with credit scores between 580 and 625. There were approximately $27 billion in subprime personal loans in 2014. Although securitization of subprime personal loans had been rare for several decades, recently, there has been a return of this practice.65

The Long-Term Risks

The rise of subprime consumer lending can, over time, create winners and losers. With expanded opportunities for borrowing, consumers with lower credit scores will have access to goods and services they need and desire. However, if they are overcharged, or are given loans regardless of their ability to pay, trouble will ensue. When consumers cannot keep up with their payments or if doing so compromises their ability to afford other essentials, individual and systemic consequences follow.66

Recognizing the risks to the public, regulators have begun to step in to curtail abuses and hold accountable those who violate the law in lending practices that affect all borrowers, including those with subprime credit scores. While default rates remain relatively low now with these subprime loans, we should guard against complacency. Despite the fact that large banks may be pulling back, the summer 2015 issue of Subprime Auto Finance News suggests that auto dealers are encouraging, not shying away from, subprime lending.67 History shows that the accumulation of excess private debt when consumer and business borrowers are already burdened leads to disastrous results.68 Moreover, creating an economy that depends upon leveraging household balance sheets of the most vulnerable is neither fair nor sustainable.

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