MOVING THE METAL
S01E07
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RECORDED 7/3/24
AIRDATE: 7/31/24

Brooke Conkle: Welcome to Moving the Metal, the premier legally focused podcast for the auto finance industry. I'm Brooke Conkle, a partner in Troutman Pepper's Consumer Financial Services Practice Group.

Chris Capurso: And I'm Chris Capurso, an associate in Troutman Pepper's Consumer Financial Services Practice Group.

Brooke Conkle: Today we're going to talk about the new CFPB report on Negative Equity in Auto Lending. Before we jump into that topic, let me remind you to please visit and subscribe to our blogs. We have two great ones that may be of interest to you; troutmanpepperfinancialservices.com and consumerfinancialserviceslawmonitor.com.

Also, let me remind you about our other podcasts that you also might find interesting. We have *The Consumer Finance Podcast*, which, as you might guess, is all things consumer finance related. *FCRA Focus*; a podcast dedicated to all things credit reporting. *Unauthorized Access*; a deep dive into the personalities and issues in the privacy, data, and cyber security industry. Finally, *Payment Pros*. A great podcast focused exclusively on the payments industry. All of these insightful shows are available on your favorite podcast platform. Check them out.

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one handy place, it also has a listing of all the firm's financially-focused attorneys. Check it out and see what you think.

For today, as I mentioned, we're going to discuss the CFPB's June 2024 report on negative equity in auto lending. Now, Chris, this report came from the CFPB's 2023 *Auto Finance Data Pilot* that was issued to major banks, finance companies, and captive lenders. This study is the first to be released using the data from that pilot.

As a starting point, I guess let's start at the very beginning. How does the bureau define negative equity? So, according to the bureau, negative equity is in those cases where the trade-in value of a vehicle, offered for trade-in, is less than the outstanding loan balance on that same vehicle. That's what the bureau is defining as negative equity. Chris, what does the study notes say about negative equity in auto finance?

Chris Capurso: Yeah, Brooke. And I think to start it off, the study itself, the report goes into a lot of detail about what exactly went into the data set for this negative equity report. And in doing so, it describes a lot about what went into the auto data pilot in general. And there's some really interesting nuggets in there that I thought I'd go over.

First, that the full data set, the entire data set that the CFPB collected through this pilot included 33.8 million loans. But, for purposes of this survey, they had some big exclusions. First, they excluded RVs, motorcycles, or other similar, and, honest to God, I don't know what this means… "non-consumer vehicle products," where they could determine whether they were actually those items or not. There could have been an RV or motorcycle sneaking into this survey and they just had no idea. Also, I'm not sure what is "other similar non-consumer." Because at last, I knew consumers bought RVs and motorcycles so I'm not entirely sure businesses – I don't know – I'm not seeing people on business trips riding motorcycles around. Maybe they do. If they are, they're obviously cooler than me. There are no exotic vehicles in this. You're not going to see the prices of these loans inflated by somebody buying a Lambo, or a Maserati, or something like that.

Brooke Conkle: Chris, are Cybertrucks included as exotic vehicles?

Chris Capurso: Well, that's a good question. I don't actually know the answer to that. Because, I mean, I wouldn't call it exotic. Maybe that's up to each person's definition. But, I mean, theoretically, it could have made it in there, because they said that only those vehicles that we could identify as being these other things didn't make it in. So, maybe there's a Cybertruck or two just hiding in this data set.

One of the more notable exclusions, all jokes aside, is that there were no terms less than three years included. Anybody going for that 24-month quick loan, they're not included. So, all of those exclusions that I just said. No RVs. No motorcycles. No exotic vehicles. No terms less than three years, that only knocked out 600,000 loans from the initial pilot. Now we're down to 33.2 million.

But then there a second row of exclusions. And those were that it does not include pre-2018 loans that were either paid in full, prepaid, repossessed, or otherwise terminated. And it also does not include refinancings. And those exclusions brought down the number significantly.

Like I said, started with 33.8. Went to 33.2. After this second round of exclusions, we're down to 21.4 million loans. So, already, I mean, we're looking at a third of the loans just knocked out by exclusions. So, I understand that they're trying to get the data set together. But it does seem like a third of the data being just excluded right off the top is pretty huge.

Beyond the info on the loans themselves, they did include some interesting info on who provided that data for the data pilot. And it's interesting that, in the study, it is very skewed to two specific types of finance entities. And that is captives, like captive finance companies, and banks. Captives had over 48% of the submissions. And banks had over 43% of the submissions.

Meanwhile, non-captive finance companies had only 8.27% of the submissions. And you think, "Oh. Well, that's interesting. But it really doesn't matter if that's what the market share actually looks like." But that's not what the market share actually looks like, because the CFPB provided that data. And, I thought that was pretty interesting data, too. Because sometimes you have to

go to sources behind paywalls or go to different types of things to try to find that industry data. CFPB just gave it to us in this. Banks are 33.3% of the auto finance market. Credit unions are 23.7. Captives are 19.8. So, they were almost 50% of the data pilot but only 19.8% of the market. And then non-captive finance companies were 12.4%. So, they were kind of close to the 8. But in terms of the overall percentage, it doesn't really match. And then buy here, pay here we're 10.7% of the market.

The CFPB also provided some interesting info just in general about the loans, including what the credit scores were at origination. So, this pilot includes a majority super prime loans. Over 53%. And then even on top of that, 18.5% were prime. So, over 71% of the loans in this are prime or super prime. That doesn't leave too much for the near prime, sub-prime and deep sub-prime categories. That's actually how Experian Velocity has those categories listed. It's about 31%. So, the CFPB was pretty close in representation there. They also provided the percentage of total loans by income at origination, which is interesting. So the income of the person who is getting the loan. Again, under 40,000. Only 13%. But then over 120,000 in income, 24%. So, it kind of goes along. I mean, we know that credit score usually has a correlation with income. And it kind of goes along with that idea where we are seeing a lot of high-credit score loans in this survey. it's kind of kind of something to keep in mind as maybe not necessary for this one because it's discussing negative equity. But as we go forward, these are the stats for the autopilot in general, the auto data pilot in general.

So, with that, we get to some of the big items in this report. And, honestly, when we and folks in our group read through this, a lot of it was, "Yeah. Of course. That makes sense.” Wasn't anything that blew our lids or made us think any differently about the auto finance market. These things seemed fairly obvious.

Among them was there's an increased risk of repossession when there's negative equity in the loan, which makes sense. Higher loan amounts in payments when there's negative equity, which really makes sense. I mean, if you're rolling in prior balances, then of course it's going to be higher than if you didn't.

Some of these are very obvious. One of the interesting things is the prevalence of negative equity. And the bureau spends a lot of time on this. They said over 10% of borrowers finance negative equity from a prior vehicle loan. And they really get into the years. Between 2018 and 2022, 11.6% of all vehicle loans in the data set included negative equity with the percentage peaking at over 17% in 2020.

And what's interesting is the bureau does know kind of that 2021 boom in vehicle prices. And how – I mean, I was shopping for a vehicle at the beginning of 2021, I certainly remember how expensive vehicles were. Also, how much I was getting for a trade-in for my car. I could not believe what people were offering for a manual GTI Volkswagen, which is why I bought a new car. But the fact that those vehicle prices were so high, the CFPB noted that, almost immediately, we had one of the quickest depreciation rates that are on record.

So, you had people paying a lot for these vehicles. And then the depreciation came down very fast because they were inflated to begin with. So now, all of a sudden, you have people who had loans that were very high for vehicles that are not valued as high. So, the CFPB posits that this could be a trend going forward, especially with – we're talking 3-to-7-year financing contracts. That this could be a trend where you have folks who bought cars that were probably a little bit inflated in value. Now that inflated value is down. And if they go for a new car, then all of a sudden, that trade-in isn't going to be the same as what they're paying. And that kind of goes to another finding, which was another obvious one. But the higher loan-to-value and payment-to-income ratios, of course. Because the loan with a negative equity isn't just a loan for that car, it's a loan for that car plus part of the prior car.

So, a lot of the findings, they do make sense. One interesting thing that honestly escaped me the first time I read it, but it can't go without mentioning, is that the report mixes up simple interest and pre-computed interest, which, especially amongst us finance folks, is just nails on the chalkboard type thing where we just cannot stand it.

They are right with a pre-computed loan. You have to do refunds. You have to consider refunds because that interest is being spread out. It's pre-computed. It's being spread out over the

course of the loan. The report calls that simple interest, that is incorrect. For anybody reading this report later on, just know that that's not right.

So, Brooke, with all that data and the different findings, what are your general thoughts on this?

Brooke Conkle: Yeah. I think one of the things that I found particularly interesting was the way that the bureau really tried to categorize income buckets. As someone who also likes to kind of think of concepts in terms of buckets, that was really helpful for me. And the data that the Bureau provided regarding kind of negative equity by income bucket was really surprising for me, in that what is telling dealers and the auto finance industry is really to focus on the middle.

The consumers who were in the kind of what we'll call the first bucket, which is income under $40,000, didn't have a ton of negative equity over time. Similarly, consumers that were in sort of the fifth bucket, $120,000 in income and over, similarly didn't also have a ton of negative equity. Really, the middle bands was where you saw the most activity for negative equity. And as Chris mentioned, the Bureau categorized the percentage of total loans that were included in the study within those kind of the three middle buckets, between $40,000 in income and just under $120,000. And so that, those three kind of buckets of income are really kind of where, for lack of a better term, where the money is. That's where the focus is going to be for terms of negative equity.

And then similarly, let's not forget Mark Twain “lies, damn lies, and statistics.” This report is looking only at a very narrow slice at the kind of auto financing that's going on, where it's heavily skewed towards banks and captives, were missing data that would come from a credit union that would come from buy here, pay here. Anything like that is not going to be reflected in this study. And that's important to remember.

Chris Capurso: Yeah. And that kind of brings to mind arguably the most surprising thing about this report, is that this was the first one. You know, like when auto data pilot went out, I'm not sure anybody would have had this at the top of the list of, "When they come out with that report, that's the one they're going to lead off with. That's the big one." And it's interesting that this was the first one. Maybe it was the one they could collect the data on the fastest so they could get

the first one out. Or maybe it points to an enforcement priority. And, I'm going to read verbatim, wouldn't normally do this, but read verbatim the final paragraph, the final substantive paragraph of the report.

“The current auto market and larger economic environment also present unique challenges. As noted above, used car prices are dropping from record high levels at a faster than normal pace. Putting more consumers at risk for owing substantial more on their loan than the vehicle's worth. Current data also show that delinquencies are rising in all credit markets, including auto lending. With financing transactions that include negative equity increasing, we may see additional consumer stress, particularly if economic conditions change. With the understanding that consumer outcomes for those who finance negative equity seem to be worse than for those who did not, the CFPB will more closely examine the data on and lender use of this practice.”

So, that goes right to the enforcement priority part of it. And it goes along with what I mentioned earlier. I think the CFPB sees a pattern. In all honesty, it makes sense. I mean, we remember a couple years ago just when dealer lots were empty, there wasn't enough supply. The car prices went really high. Used car prices weren't really high because dealers wanted to sell something. And now we're starting to come into a little bit more of an equilibrium where there is inventory, where there are cars available. And they're not nearly as expensive as they were. But everyone is sitting on these cars that were much more expensive. I mean, it's kind of a microcosm of the housing market where everybody's sitting on their house at that lovely 3, 3.2 rate. While the rates are, in reality, 7, possibly above. And it's like, "Well, they're all sitting on that." But the difference is a house is it's a 30-year mortgage. It's not a four or five-year retail installment or loan contract.

And also, I mean, some people get tired of their houses as fast as their cars. But, I mean, generally, cars have a little bit more turnover. So it's an interesting note by the CFPB. And it does make sense given the data that they saw. For those out there who do finance vehicle purchases, this is something to keep in mind. That even if the numbers aren't crazy yet with – they noted over 10% of borrowers finance negative equity. I mean, that still leaves just under 90% of borrowers who didn't. But the fact that they project this to increase and that the CFPB picked this as the first thing that they were going to cover really leads me to believe that this

could be a focus going forward. And it makes me wonder what number two is going to be. I mean, what about you, Brooke?

Brooke Conkle: Yeah. I agree wholeheartedly. Just as you mentioned, I don't think anybody had this on their top 10 list of topics that the CFPB would release a report on with all of this data that's in hand. But it is really, as you mentioned, an accurate reflection of the marketplace. This is something that consumers are seeing day-in and day-out. And, also, by extension, auto finance companies are seeing routinely that we anticipate is going to increase. With paragraphs like the one you read, Chris, I think we all kind of see an enforcement action on the horizon.

Chris Capurso: Yeah. And if there's nothing else about the CFPB, they are predictable. And they do write about – I shouldn't say they're predictable. When they write something, it's usually going to come out. Nobody should have me on the record of saying they're predictable. Because who knows what's going to come? But if they're going to write it, it's probably going to happen. So at least in that sense, they're predictable. Until two weeks from now when I read somewhere in some trade magazine that I said that the CFPB is all predictable. As if somebody's going to quote me.

With that, we're going to wrap up today's podcast. Thank you to everybody for tuning in. Don't forget to check out our blogs where you can subscribe to the entire blog or just a specific content that you find most helpful. Our two flagship blogs are the consumerfinancialserviceslawmonitor.com and the troutmanpepperfinancialservices.com blogs.

While you're at it, why don't you head over to troutmanpepper.com and sign up for our consumer financial services mailing list, so you can stay abreast of current issues with our insightful alerts and advisories and receive invitations to our industry insider webinars. And, of course, please mark your calendars for a great new episode of *Moving the Metal*, which will be released in two weeks.

For Brooke and I, thanks for listening. And until next time.

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