

Compliance in a Sub-prime World

by : Gil Van Over

I checked into a hotel last week that had just changed brands. The plush new carpets and fresh smelling bedding and new plasma television gave clues that the new owners had spent serious cash in remodeling the facilities.

Other disturbing clues, though, started tickling my clue-o-meter (that sneaky gut feeling that not everything is right). I heard one clerk explaining to the guest she was trying to check in that, "This is my second day on the job." Another clerk was apologizing to the caller on the other end of Watson's invention that, "I don't know how to adjust your bill and the manager is not in right now."

These didn't affect me, so I ignored the apparent lack of training as I quickly checked in and headed to the elevator.

There I met a young man pushing a room service cart. As I followed him in, and being closest to the buttons, I asked him what floor he needed. His response, "I'm not sure, try five," at first seemed odd. The old clue-o-meter still had not kicked in yet.

I pushed the button for my floor and we ascended.

When the elevator door opened at the fifth floor, the young man hesitatingly peeked out, looked at the directional sign with room numbers and arrows and said, "Nope, not this floor, we need to keep going."

Clue-o-meter kicked in. "What room are you delivering to?" I asked. "1102."

I pushed 11 for him and made a note to self...order a salad, not a hot entrée, for dinner.

Clues

Similarly, any dealer that does a fair amount of sub-prime business should have a clue-o-meter working in overdrive.

Any reader of the *Wall Street Journal* or the Money section of *USA Today* knows of the crisis in the sub-prime mortgage industry. At first, many experts in the auto industry tried to minimize the effect of the crisis to the auto sector, noting the differences between the two industries. Unfortunately, there are many similarities, not the least of which is the consumer.

Some clues are published. Others are observations. Some of the sub-prime clues dealers need to keep in mind while formulating a business plan for 2008 include:

- More consumers' credit scores continue to slide into the loosely defined sub-prime range.
- The sub-prime mortgage crisis brings a higher level of regulatory scrutiny. Regulators being regulators, they will likely prefer to put the scope on all types of sub-prime lending and not worry about the differences between industry segments.

- Of the numerous cases I have worked on as an expert witness, all of the plaintiffs have been sub-prime customers.
- Sub-prime business can be profitable.
- The demographics in a dealer's footprint may require that the dealer accommodate the sub-prime business or perish.
- Many times while conducting compliance training, sub-prime sales and finance managers voice the loudest opposition and greatest resistance to the compliance message.

Potential sub-prime compliance Issues

While most of the potential compliance issues in prime retail and lease transactions exist with sub-prime transactions, a few of the issues are exacerbated in a sub-prime deal.

Acquisition fees

Ask industry folks to define a sub-prime deal and you will normally get one of two responses. The first is any deal below a 600 bureau score. The second definition is any deal funded by a sub-prime company.

I submit a third definition. Any deal that is charged an acquisition fee by the lender (excluding the \$100 bank fee by prime lenders in the Southeast that is legally passed along to the customer) is a sub-prime deal. The dealer has to pay the lender for the right to purchase the receivable.

Any fee that a credit customer pays that a cash customer does not pay is a finance charge and must be included in the APR calculation. A sub-prime acquisition fee certainly falls within that definition. This becomes the one different compliance issue that prime transactions do not have. It becomes a compliance issue when the dealer tries to pass along the fee to the consumer and does not increase the APR accordingly. If a dealer does disclose the acquisition fee on the retail installment sales contract and adjust the APR accordingly, the contract will likely exceed state maximum rates.

Best practice

- A dealer must take the sub-prime acquisition fee as a cost of goods sold and not increase the retail price of the vehicle to cover the fee; and
- Work sub-prime deals backwards. In other words, submit the credit application for approval and structure. Then determine which vehicles in your inventory have enough margin to absorb the acquisition fee, then charge the consumer the same price whether he finances the deal with your or she writes you a check.

Bank fraud

Realistically, making a credit decision is much simpler than many folks make it out to be. Ultimately, every underwriting algorithm and corresponding variables incorporate the old-school three Cs of credit: character, capacity, collateral.

Character refers to the consumer's *willingness* to repay the debt and is measured by the consumer's stability (time at job, time at residence, buying or renting, etc.) and the consumer's past pay history.

Capacity means the consumer's *ability* to repay the debt and is measured by debt to income and payment to income ratios as well as disposable debt.

Collateral is simply the loan to value and is important in the event the consumer is no longer willing or able to pay.

Bank fraud is the dealer's or consumer's intentional and criminal act to provide false information to the lender in order to improve the credit application in one or more areas of the three Cs. Bank fraud includes straw purchases, power booking, falsified income, falsified time on job or residence, and inaccurate down payment representation.

In the end, the dealer is likely the one left being asked for the payoff on a deal that smells like bank fraud.

Best practice

- Implement a policy that forbids bank fraud and requires the sales and F&I managers to take a greater responsibility to verify the information being provided to the dealer by the consumer before passing it along to the lender;
- Require that all stips sent to a lender be retained in the deal jacket;
- Make a manager sign the book out sheet confirming the options and mileage are correct;
- Periodically verify that the credit application information on the paper document is consistent with the information provided to the lenders via DealerTrack, Route One and/or CUDL;
- Do not permit any consumer to sign a blank document, including credit applications and contracts; and
- Most importantly, establish a consistent audit program to verify five percent of your deals monthly.

Optional F&I products

The sale of F&I products on sub-prime deals is sometime tenuous. The two potential compliance issues with the sale of optional products are representing optional products as products required by the lender and not offering all the products to every customer.

If a dealer makes gap a required product, it becomes a finance charge by definition and must be included in the APR calculation (see sub-prime acquisition fees above).

If a dealer does not offer every product to every customer, prime or sub-prime, it runs the risk of paying off a deal when credit life was not offered, or replacing tires because tire and wheel coverage was not offered.

Best practice

- Ensure that optional products are represented as optional. The use of a menu or similar selling tool should have the required disclosures;
- The word tracks the F&I manager uses must indicate that the products are optional;
- Look at penetration numbers. If your dealership is at 100 percent penetration on any optional F&I product, it is not likely being represented as optional; and
- Make sure that every product is offered to every consumer. If the lender's call back is restrictive, additional cash down from the customer to cover the premium will usually keep the line five and/or payment call the same. At a minimum, have the customer pay cash for the product.

The clues are there. 2008 is going to be the year of sub-prime, and maybe not in a good way. Listen to your clue-o-meter and include a remodeling of your sub-prime business in next year's business plan. Done correctly, sub-prime can add a nice benefit to the bottom line and minimize potential litigation or regulatory oversight.

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