



Rate Spread Controversy: Problem and Opportunity

by Alex Kurkin

Dealers are perpetual targets of consumer groups. Recent attacks have focused on rate spreads. While these attacks had first been limited to court cases, they are now moving to legislative forums.

As it relates to dealers, the term rate spread has been overused and misstated as a result of a common misunderstanding regarding the dealers role in the financing. As the top of any retail installment contract reflects, the dealer is the lender. That the dealer immediately assigns the contract to a bank or captive does not change the dealer's original lender status. Unfortunately, most dealers and experts misunderstand this reality and characterize dealers as credit arrangers or other similar terms. This mischaracterization has, in part, resulted in today's rate spread controversy.

When we finance our home purchase through a prime lender, we usually get a notice that the lender has assigned the note and mortgage to another institution that operates in the secondary market such as pension funds, insurance companies, etc. In fact, at the very closing we may get a disclosure that we may later receive an assignment notification. In fact, most originating residential mortgage lenders do not keep their paper and, instead, sell the paper in the secondary market at a premium or profit. [Without that profit, they have no reason to originate loans.]

An F&I department is no different than an originating mortgage lender. Both issue loans after first establishing a contractual relationship with other institutions to whom they sell the loan at a premium or profit. In the automotive industry, that premium is called a rate spread.

Why haven't consumer groups targeted the premiums earned by mortgage lenders? Examine the presentations. When presenting mortgage loan terms, a Bank of America loan officer does not say "We can get you a 7.5% rate through some secondary market investor." Instead, the loan officer is more apt to simply say, "We can finance you at 7.5% without reference to another institution." The dealer's finance manager, on the other hand, generally uses the former presentation – "We can get you a loan through Bank of America at 7.5%."

When F&I managers mention the intended assignee, the consumer is more prone to assert that this presentation caused them to believe the dealer was trying to secure the best financing terms for the consumer. It is this claimed perception that fueled the rate spread controversy in courts, and now fuels legislative discussion and resolution. [Incidentally, the best practice approach does not negatively impact the spot delivery practice.]

Both Louisiana and California have legislative dealer rate spread caps. Both caps are more generous than what market forces permit and what most prime banks and captives allow and, therefore, do not result in financial hardship. Still, once dealers succumb to rate spread regulation, they risk having that cap reduced, and allowing politicians to control their margins.

Effective rate spread legislation, assuming that it passes constitutional muster when tested, is suspect. Supply and demand ultimately dictate interest rates and there is no reason why dealers should allow the captives and lenders to make the F&I profit that dealers would have otherwise made but for the cap. Not surprisingly, finance sources are not opposing these legislative efforts.

As this controversy ripens, dealers, like some banks, may ultimately warehouse or keep their own loans and fund them by securing a line of credit against them. Dealers would originate the loan, keep it, subcontract the servicing of the loan, and retain the entire interest revenue. Ultimately, this solution should be more profitable for dealers since the spread between a consumer's interest rate and a dealer's line of credit rate will be greater and more profitable than the current average rate spread.

Therefore, while the current! rate spread controversy may have been occasioned by the industry's misuse or misunderstanding of terms and its role in the finance process, this controversy may present opportunity. To take advantage of this opportunity however, dealers would have to, for the first time, assume the role they already have the role of a lender.