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CFPB sets the stage for the federalization of auto credit

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The Consumer Financial Protection Bureau on Sept. 17 proposed to oversee nonbank auto finance companies, noting that the action was undertaken after it uncovered auto lending discrimination at the banks it supervises. The CFPB release also noted that auto loans are the third largest category of consumer debt after mortgages and student loans. I do not have the background to comment on the CFPB's statistical analysis of auto lending practices to discern the presence of discrimination, though I am sure there are pockets as exist in any society.

Leave it to Washington to pass legislation and then write thousands of pages of regulations to "reform" and more tightly regulate and "safeguard" an industry when a simple five page document that requires depositories to operate with 15% to 25% more common equity capital would have sufficed. Maybe safety is a distant secondary concern to agendas? Whether well intentioned or an agent of an agenda, the CFPB is funded by the Federal Reserve and is thereby outside direct oversight of Congress via appropriations. It seems to me that the CFPB has a really long policy-making leash that probably will get much longer in time.

What was striking to me about the release is what appears to be the creeping and maybe soon to be rapid federalization of another credit product. You should not doubt that tighter regulation of auto finance will lead to less availability, which in turn will lead to demands for government support via subsidies or maybe direct government underwriting in time. What began as an effort to provide liquidity to the mortgage market in the 1930s through various programs morphed into a market that came to be dominated by the government-sponsored enterprises and which ended in tears when the bust came in 2008.

The federal government increasingly dominates the rapidly growing student loan market. The student loan market seems to be a ticking time bomb given the explosion in lending. If there is no detonation like that which occurred in the mortgage market, economic growth probably will be limited as imprudent borrowers spend years servicing debt that cannot be discharged in bankruptcy. Look for a federal bailout when the political conditions are right.

So what do we make of the CFPB's auto credit actions that will bring the likes of Toyota Motor Credit under its purview? One is that it is becoming increasingly clear — at least to me — that Dodd-Frank is going to be as important for finance as the authorization of the Federal Reserve in 1913 and banking legislation adopted in the 1930s that led to deposit insurance and Glass-Steagall, among other things.

In the case of the Fed and FDIC, both pieces of legislation had their roots in a desire to stem the age old nemesis of bank runs. The Fed was to be a lender of last resort to banks — a function it performed exceedingly well in 2008 and 2009. The FDIC was intended to provide assurance to consumers and small businesses that their deposits, up to a limit, were safe. The FDIC has performed this core function well, though I think it is a fair question as to how good it and other regulators are at regulating lending decisions. Regardless, nothing is free; the cost, depending upon your point of view, has been mission creep for these institutions. Today, both arguably are instruments of government that direct credit to achieve government policies through various lending mandates and economic objectives such as full employment.

Another take I have on the CFPB's action is that auto lending is the latest credit function that probably will be indirectly taken over by the government. Historically, credit was extended by bankers following the "C" motto for lending that involved evaluation of character, capacity (to pay), capital, collateral and (market) conditions. Government is increasingly interjected into the credit process as "guarantor" provided that some benchmark is met. The conversion of the old General Motors Acceptance Corp. into a bank holding company that today is Ally Financial Inc. is a case in point. Deposit insurance was extended to historically one of the largest captive auto finance companies.

Under the guise of fair lending and anti-discrimination initiatives, the CFPB is going to regulate a vast area of finance that is not directly controlled by banks. Financing of captives traditionally has relied heavily upon the securitization market, plus some combination of bank loans, unsecured bond offerings and support from the parent company. If the subprime auto market has a spectacular blow-off in the next downturn, maybe there will be a push by some in Washington to form a GSE to back auto loans? And it does not take too much imagination, at least by me, to see how the CFPB could further expand its oversight to other sectors. General Electric's decision to spin-out most of its retail operations via Synchrony Financial looks to be really well-timed beyond management desire to shrink the size of General Electric Capital Corp.

The CFPB's actions have implications for investors too, though Dodd-Frank is more important than the CFPB's land grab. At a very base level, the utility model for an increasingly large swath of finance has been set. Investors will always be able to time their entry and exit to make great money or lose a fortune in a highly regulated industry, but all else equal the sector should trade at lower multiples than what used to be the case. ROE is lower, and earnings growth will be slower. Citigroup CEO Mike Corbat was recently quoted saying as much, but that the sector may see less volatility in his view. Maybe, but many banks seem to find themselves at the precipice every generation or so. And who is to say that the extortion payments Washington has extracted from the banks for the mortgage fiasco that it helped create will not be demanded from consumer lenders after a nasty recession at some point in the future?

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