"Reckless Driving": Implications of Recent Subprime Auto Finance Growth

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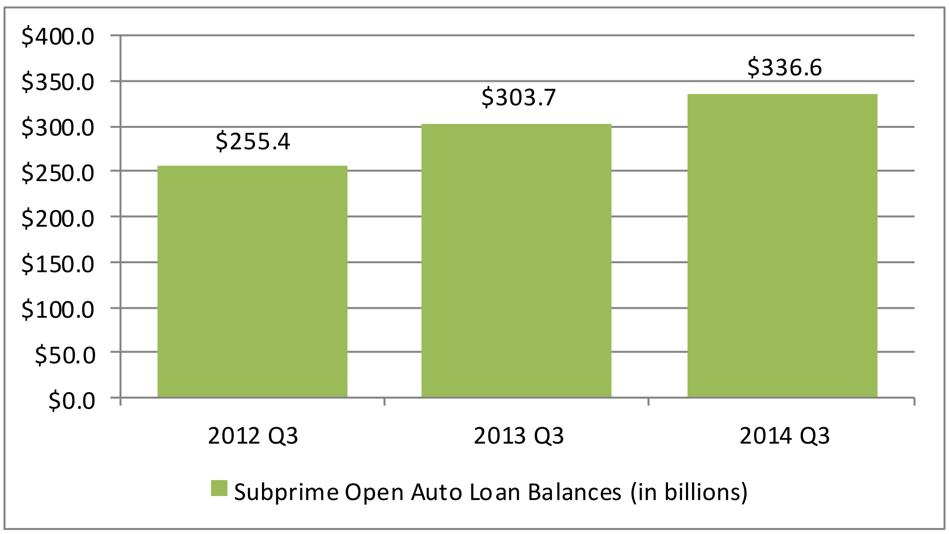
The auto finance market has grown significantly in the past few years. According to Experian Automotive, outstanding auto loan balances reached a record-breaking $870 billion in the third quarter of this 2014, an increase of 9.9% and 24.5% over the same periods in 2013 and 2012, respectively.[1] As of the end of the third quarter of 2014, loans to consumers with below prime credit comprised 38.7% of open accounts, totaling over $336 billion.[2] Also, according to the Federal Reserve, "The dollar value of originations to people with credit scores below 660 has roughly doubled since 2009, while originations for the other credit score groups increased by only about half."[3] Likewise, subprime auto loan securitization issuances stood at $13.7 billion in 2013, more than 12 times the issuances in 2009.[4]



This growth raises concerns that subprime auto lending practices risk causing problems in the larger auto market. In this article, we look at delinquency and default rates and explore whether auto loans are in fact performing better than mortgage loans did in the period before the mortgage meltdown or whether the current statistics may be misleading. We also look at the issue of lengthening loan terms and rising loan-to-value (LTV) ratios and what those changes mean for potential risk. Finally, we explore the recent discussion about a potential "bubble" in the auto lending market and highlight existing abuses that, if eliminated, would reduce risks in the market.

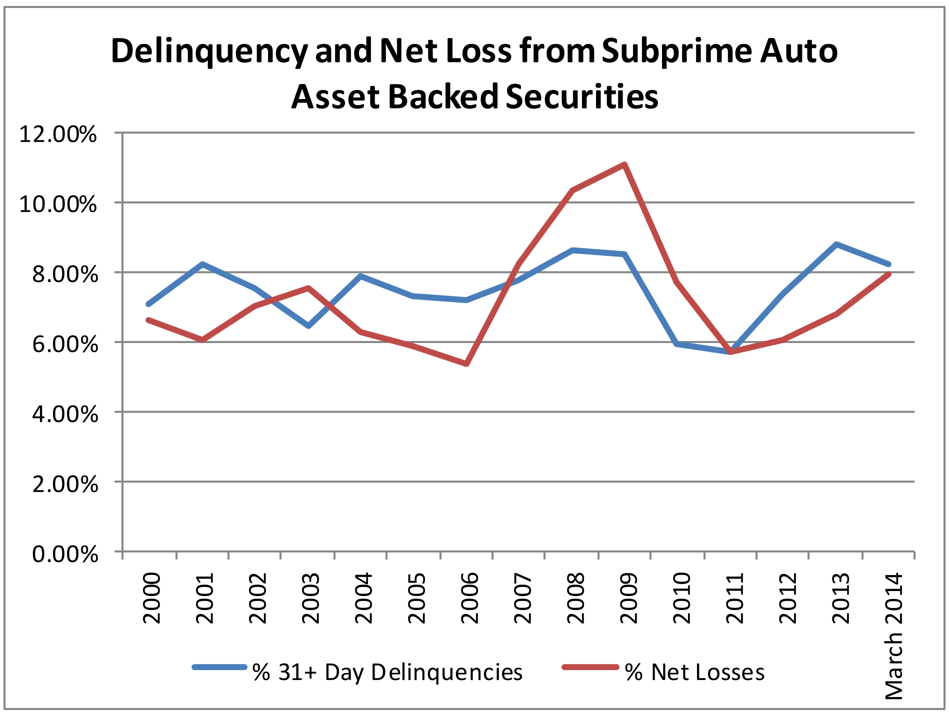
We find:

- Repossession rates have climbed significantly in the last four quarters;
- Lenders are loosening underwriting standards and extending loan terms while increasing auto loan amounts, increasing the risk of defaults, particularly for subprime auto loans;

- Dealer interest rate markups and selling and financing add-on products exacerbate the risk of default and increase risk disproportionately for borrowers of color; and
- Efforts to minimize auto loan repossession rates by comparing them to the mortgage market are misleading.

<u>Repossession rates have climbed significantly in the last four quarters</u>

In every quarter since 3Q 2013, repossession rates have been significantly higher than the same quarter in the previous year. Most alarming, the 2Q 2014 repossession rate was 70% higher than 2Q 2013. This increase is also evidenced in the auto loan asset backed securities (ABS) market. Both delinquency and net loss rates have increased from their post-recession lows in 2011, and are projected to continue that trajectory in the near future.[5]



Some lenders have pointed to recent flat or diminishing quarterly delinquency rates as evidence that the auto lending market is fine. However, the speed of repossession also creates an environment where a spike in the repossession rate can occur without a parallel spike in seriously delinquent accounts. Lenders can initiate repossession if they believe the collateral is under threat. As such, it is very likely that as signs of a deteriorating market become clear, lenders accelerate repossession at an earlier point in delinquency.

Evidence of this can be gleaned from comparing the increase in the repossession from 2Q 2013 to 2Q 2014 to changes in delinquencies. In that time period, the repossession rate increased 70.2%, while the 60-day delinquency rate only increased 6.8% and the 30-day delinquency rate remained flat. In another example, in comparing the year-over-year period between Q1 2013 and Q1 2014 the repossession rate increased, while 60 and 30-day delinquencies *fell*.[6]

	Year-over-year Change in 30-Day DQ	Year-over-year Change in 60-Day DQ	Year-over-year Change in Repo Rate
3Q 2013	-3.4%	0.0%	54.4%
4Q 2013	-3.5%	0.0%	42.8%
1Q 2014	-5.0%	-1.7%	36.5%
2Q 2014	0.4%	6.8%	70.2%

In many markets, a rise in delinquencies serves as a harbinger of potential defaults. In this market, delinquency rates can remain artificially low due to the quick repossession process.

Added Risk from Looser Underwriting

One explanation of increased repossession rates is changing underwriting standards and loan terms for subprime auto loans. The collapse of the subprime mortgage lending market sent investors seeking higher yields to the subprime auto lending market. In order to make their loans more attractive to auto dealers, lenders have relaxed their underwriting standards.[7] A measure of the loosening standards is rising loan-to-value (LTV) ratios and lengthening loan terms, both of which are more pronounced in subprime lending.[8] The combination of allowing a higher LTV and extending the loan term makes the monthly payment appear more affordable to the borrower in the short-term, but increases the risk that the borrower will be unable to repay.

Lenders routinely allow dealers to make loans that exceed the value of the car.[9] LTV ratios above 100% allow a dealer to finance additional insurance products, such as extended warranties and credit insurance policies. Higher LTV ratios also allow dealers to finance "negative equity", which is the amount that is still owed when a trade-in vehicle is worth less than the outstanding balance of the loan on the trade-in.

To make monthly payments seem affordable on larger auto loans, lenders are extending loan terms to as long as 96 months. Longer loan terms result in the borrower owing more than the car is worth for the bulk of the loan term. The Office of the Comptroller of the Currency (OCC), which regulates national banks, recently warned that, "The average loss per vehicle has risen substantially in the past two years, an indication of how longer terms and higher LTVs can increase exposure."[10]

LTV ratios and loan terms on subprime new car loans are significantly higher than the industry average compared to prime loans.[11]

	Average Loan Term	Average LTV	Average Rate	Average Amount Financed	Average Monthly Payment	Average Interest Paid over Loan Life
Super Prime	61.3	98.8%	2.90%	$25,936	$456	$1,990
Prime	67.5	114.3%	3.72%	$28,802	$471	$3,139
Nonprime	69.7	122.2%	5.33%	$29,385	$487	$4,869
Subprime	70.6	125.5%	8.88%	$27,828	$499	$8,048
Deep Subprime	70.9	126.0%	12.12%	$25,428	$496	$10,321
Industry Average	***65.0***	***110.4%***	***4.37%***	***$27,430***	***$471***	***$3,424***

This chart also shows how misleading the monthly payment can be for consumers. Lengthening loan terms can lower the monthly payment to finance a more expensive loan with higher rates (influenced by rate markups) and LTV ratios (influenced by add-ons and negative equity). While the monthly payments for deep subprime loans are only 8.7% higher than loans in the super prime tier, the total interest paid over the loan's life is over 400% between those same tiers.

Risk Layering and lending discrimination

Loosening underwriting is only one part of the puzzle in auto lending. There are other practices shown to be abusive that also increase the cost of an auto loan and subsequently, the risk of default. Because practices such as dealer interest rate markups and financing add-on products have been shown to disproportionately affect borrowers of color, they are of particular concern.

The practice of dealer interest rate markups has shown to promote significant unfairness in the market, particularly for borrowers of color. For car loans financed through the dealer, the loan's interest rate has two components. The first is the "buy rate" that the financial institution buying the finance contract offers the dealer. This rate is calculated based on the borrower's credit and financial information that the dealer collects and provides to the financial institution. The second component of the interest rate is the dealer markup, which the dealer adds to the "buy rate" and keeps most of the difference as compensation. This practice has been the subject of several lawsuits over the past two decades, which provided strong evidence that borrowers of color paid disproportionately higher interest rates than similarly-situated white borrowers.

Recent CRL research also found that African-American and Latino car buyers reported being sold more add-on products than similarly-situated White borrowers.[12] It is possible, then, that the same consumer could receive an interest rate with a disproportionately high markup, finance several add-ons along with negative equity from a trade-in resulting in a high LTV ratio, and stretch out the loan to 96 months to keep the monthly payment "affordable." This kind of risk layering was a hallmark of the subprime mortgage market before the meltdown, and should be considered when evaluating potential abusive practices.

Comparing auto repossession rates to mortgage default rates is misleading

Those who argue that the auto market is not facing similar issues that the mortgage market did before the housing meltdown usually start with a comparison of delinquency and default rates. Specifically, they claim that in comparison to the mortgage market, auto loan delinquencies and default rates look much lower. However, these claims are misleading for several reasons.

There are two main faults comparing these rates between markets. First, the delinquency and default rates used are a snapshot in time measurement. These rates are calculated by taking the total number of accounts outstanding and dividing that by the number of accounts in delinquency (meaning that the consumer is behind on their payments) or in default (the point at which the lender seeks to recover the collateral). Data on the cumulative number of delinquencies and defaults over a period of time is much more revealing because that data show the overall impact on the market, and is virtually never reported in the auto market.

The second fault in the comparison is that auto lenders can repossess a car in about one-tenth the time it takes to foreclose on a house. On average, a lender repossesses a car within 48 days, whereas the average foreclosure takes 577 days.[13] A delinquent home loan stays on the delinquency and default report until the home is foreclosed, which means that those loans are included in the delinquency and default rates for a long time. Conversely, auto lenders are able to clear delinquent loans off the books relatively quickly.

In order to compare the two rates, the difference in time between car repossession and home foreclosures has to be taken into account. Loan-level data would provide more specificity, but it is possible to estimate what the car repossession rate would look like if repossessions took as long as foreclosures with this calculation:

A) Auto Repossession Rate (Source: Experian)	0.62%
B) Days Until Repossession (Source: CNW Marketing Research)	48.3
C) Days Until Foreclosure (Source: RealtyTrac)	577
Equivalent Auto Repossession Rate = (A x C) / (B)	**7.41%**
Current Home Foreclosure Rate (Source: Mortgage Bankers Association)	**2.65%**

What this calculation shows is that the speed of repossession distorts the actual conditions in the market, particularly when compared to the foreclosure rate. Seen another way, if the foreclosure process operated at the same speed as the repossession process, the home foreclosure rate would look much smaller:

Current Foreclosure Rate (Source: Mortgage Bankers Association)	2.49%
Days Until Repossession (Source: CNW Marketing Research)	48.3
Days Until Foreclosure (Source: RealtyTrac)	577
Equivalent Foreclosure Rate	**0.21%**
Current Auto Repossession Rate (Source: Experian)	**0.62%**

In either comparison, the repossession rate is almost three times larger than the equivalent home foreclosure rate. What this analysis shows is that the comparison between the two markets is misleading, and the comparison should not be the basis for evaluating the overall health of the market. Other factors need to be taken into account.

Conclusion

Regulators have taken notice of unfair, deceptive, and discriminatory practices in the auto lending market and begun to take action, but need to do more. In December 2013, the Consumer Financial Protection Bureau (CFPB) and the U.S. Department of Justice (DOJ) entered into a settlement with Ally Financial. Ally agreed to pay $98 million in restitution and penalties over alleged discrimination in connection with loans to borrowers of color. This discrimination was due to the practice of dealer interest rate markup. DOJ has also stated that the CFPB has forwarded several other complaints to them for similar discriminatory impact. Those cases remain open. Last month, the DOJ and the US Attorney for the Southern District of New York issued subpoenas to GM Financial (formerly AmeriCredit) and Santander, two major auto lenders to probe potential issues with loans packaged for sale as securities.[14] Santander in particular is no stranger to regulatory and legal scrutiny – they have been charged with various violations of the Fair Debt Collection Practices Act,[15] Fair Housing Act and Equal Credit Opportunity Act just in the past two years.[16] Reports also indicate that the Manhattan District Attorney has opened his own investigation into subprime auto abuses.[17]

Regulators and law enforcement, however, should pay more attention to well-known and well-documented abuses in the auto lending market to stop increasing levels of default. While one Moody's analyst suggested, "Instances of fraud and questionable lending need to be addressed before they become systemic issues," recent evidence suggests that the problems are already systemic.[18] One solution is to eliminate those practices that have a historic pattern of abuse, namely dealer interest rate markups. Dealers already receive compensation in forms other than interest rate markup, and those other forms have far less risk of discrimination and unfairness than interest rate markup. Regulators should also strongly consider applying a consistent ability-to-repay standard for auto lending, and ensure that lenders are exercising appropriate underwriting practices.

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[1] Experian Automotive, *State of the Automotive Finance Market, Third Quarter 2014,* Melinda Zabritski.

[2] Experian Automotive, *State of the Automotive Finance Market, Third Quarter 2014*, Melinda Zabritski.

[3] New York Federal Reserve, *Just Released: Looking under the Hood of the Subprime Auto Lending Market*, Liberty Street Economics, Andrew Haughwout, Donghoon Lee, Joelle W. Scally, and Wilbert van der Klaauw, Aug 14, 2014.

[4] Standard & Poor's Ratings Direct, *U.S. Subprime Auto Loan ABS Tracker: June 2014*, Steve D. Martinez and Rahel Avigdor.

[5] Standard & Poor's, *As Subprime Auto Lending Heats Up, ABS Transactions Remain Adequately Protected Against Increasing Credit Risk*, Amy S. Martin and Mark M. Risi, July 22, 2014.

[6] Experian Automotive, *State of the Automotive Finance Market*, Melinda Zabritski.

[7] Both the Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices (Jan 2014) and OCC Survey of Credit Underwriting (2013) report underwriting standards as "easing" in the years following the recession.

[8] Experian Automotive, *State of the Automotive Finance Market, 4Q 2013*, Melinda Zabritski.

[9] According to the latest Experian Automotive data available (4Q 2013), the average LTV ratio for new cars was 110.4%, and 133.8% for used cars.

[10] Office of the Comptroller of the Currency, Semiannual Risk Perspective, Spring 2014, p31.

[11] Experian Automotive, *State of the Automotive Finance Market, Fourth Quarter 2013* (Figures on LTV ratios not reported beyond this quarter.)

[12] http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/negotiating-on-car-loans-doesnt-help.html

[13] RealtyTrac U.S. Foreclosure Market Report, 2Q 2014. The average time needed to finalize a foreclosure in 2Q 2014 was 577 days. CNW Marketing Research, *Document 1805: Repossession Data*. In the years covered by this document, the average time needed to successfully repossess a vehicle was between 4.1 and 6.9 weeks.

[14] New York Times, *Santander Consumer Gets Subpoena in Subprime Car Loan Inquiry*, Michael Corkery and Jessica Silver-Greenberg, Aug 7, 2014.

[15] Knoxville Daily Sun, *Madrid-based bank, Santander, bilking billions of dollars from American consumers*, Jeaneane Payne, Aug 6, 2012.

[16] Wall Street Journal, *Providence, RI, Files Federal Lawsuit Against Banco Santander*, Julie Steinberg, May 29, 2014.

[17] New York Times, *Santander Consumer Gets Subpoena in Subprime Car Loan Inquiry*, Michael Corkery and Jessica Silver-Greenberg, Aug 7, 2014.

[18] Moody's Analytics, *Is U.S. Auto Lending About to Bubble Over?*, Christian deRitis, Aug 12, 2014.