Not Yesterday's Subprime Auto Loan

Economic Trends Commentary

Amy Crews Cutts
SVP-Chief Economist

Dennis W. Carlson
Deputy Chief Economist

August 25, 2014

There has been a great deal of attention recently on the topic of auto lending, with a particular focus on "subprime lending." The tone of many of the articles on subprime lending is negative. Many are chastising lenders and investors for "subprime shenanigans," suggesting that, similar to the mortgage issues that precipitated the financial crisis, there is a bubble being created that is ready to burst. Others criticize the often high interest rates that borrowers with subprime credit must pay to obtain financing and feel that the practice is unfair and that rates should be capped.

Surprisingly little data has been shared in the press. Many of the arguments have been rhetorical, based on the following premise: Subprime lending caused the financial crisis, ergo subprime lending is dangerous. This generalization, however, does not always account for actual subprime loan data. This Economic Commentary will present an up-to-date analysis showing the current state of subprime automotive lending.

Why Subprime Is Necessary

A fair and functioning "second-chance" market is necessary for a fully-functioning economy. In many cities in America, an individual's job prospects are limited without a car. In the absence of a subprime auto loan, many would be unable to finance a car and therefore face difficulty obtaining and maintaining employment. Many suffered job loss, foreclosure, or other hardships during the Great Recession and, as a result, became delinquent on one or more debts. These delinquencies or defaults may have put their credit scores into the subprime range for now, even if the underlying economic stress has been reduced.

Moreover, in a well-regulated financial market, rates are typically driven by competitive pressures, and predatory or discriminatory behaviors are prohibited by law. Borrowers who have credit scores in the subprime range have proven over time to have higher incidences of default on future obligations and thus are usually offered credit at higher interest rates than those with prime-grade credit scores. If banks and other mainstream financial institutions are not making credit available in the subprime market, borrowers may find alternative sources of credit – or go without. But these substitute sources often provide loans at even less favorable terms, such as with extremely high interest rates or loan terms that are outside of the mainstream lending market.

If a borrower with subprime credit obtains a loan from a financial institution that reports the complete payment histories of their clients to the national credit reporting agencies, and that borrower makes timely payments on that loan and other credit obligations, then over time that borrower's credit score will likely improve, possibly enough to qualify for prime credit terms. If, however, the subprime-score borrowers are precluded from mainstream sources of credit, it becomes more difficult for those borrowers to improve their credit scores. Auto financing in the subprime segment adds to the benefits by enabling credit-worthy consumers to obtain reliable transportation and acquire a valuable, albeit depreciating, asset.

A fair and functioning "second-chance" market is necessary for a fully-functioning economy.

We make these statements based on subprime lending specifically and the opportunities that fairly underwritten and priced loans provide to consumers. It is important to note that while predatory lending, which encompasses practices that are designed to take advantage of consumers, is often associated with subprime lending, they are not equivalent terms. That is, just because a loan is subprime does not imply it is also predatory. The provisions under the Dodd-Frank Act regarding Unfair, Deceptive or Abusive Acts or Practices (UDAAP) covers unfair predatory practices in all aspects of lending and commerce, including auto finance, and the Consumer Financial Protection Bureau (CFPB) is responsible for enforcement. Moreover, the CFPB has been particularly aggressive enforcing antidiscrimination laws, which should cause auto lenders to improve their underwriting, statistically base their credit and pricing decisions, and monitor more closely their dealer partners for compliance.

Today's Subprime Lending Environment

With respect to the statements regarding a potential subprime lending bubble, we have examined data aggregated from the credit reports of more than 210 million consumers in the Equifax credit repository to evaluate whether certain traditional characteristics of a bubble are evident. Specifically, the data evaluated shows that subprime lending in the auto sector has been fairly stable since 2012; that originations have been shifting toward the higher end of the subprime spectrum; and that recent subprime vintages have been performing well.

In a well-regulated financial market, rates are typically driven by competitive pressures, and predatory or discriminatory behaviors are prohibited by law.

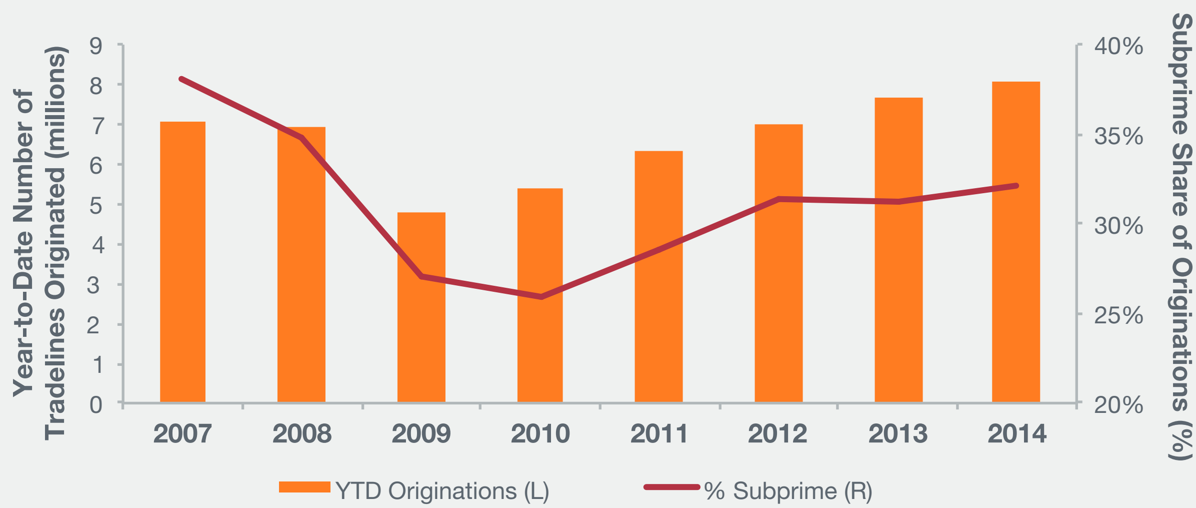
For reference, looking at the mortgage market prior to the financial crisis, there were three critical components to the bubble formation: (1) rising asset prices (i.e. home prices) fueled speculation in residential real estate; (2) new home construction was at all-time high for a sustained period and exceeded population growth; and (3) the share of mortgages originated to subprime credit borrowers was rising at a time when home purchases were at record levels. As the number of borrowers who were well-qualified to finance a home purchase did not rise in tandem, the credit bubble was fueled by inappropriate lending, which in turn fed the asset bubble.

While there are always key differences in the housing market compared to the auto market, including housing as a potentially appreciating asset versus an auto that is likely a depreciating asset, there are some similarities in factors that indicate some effervescence such as quickly rising sales of new cars and an even faster rate of increase in auto lending. But looking closely at those similar factors, we see that the auto market of today is just now recovering to pre-recession levels and, unlike the mortgage market immediately prior to the recession, the auto market was not in the same frenzied state at that time. For example, new car and light truck sales reached their peak level in the first quarter of 2000 and averaged 16.96

million units for the six-year period ending December 2005.[1] Even with these high sales volumes of new cars, the average age of a car on the road rose by almost a full year, from 8.9 years old in 2000 to 9.8 years in 2005.[2] Today the average age of a registered car stands at 11.4 years and new cars and light truck sales have totaled 15.98 million units over the twelve months ending July 2014.[3] Clearly there is not an asset bubble in the auto market today.

In Figure 1 we turn to the Equifax data on auto lending. On a year-to-date basis, the volume of loans originated has been increasing on a linear path since 2009, much like auto sales, but the share of these loans that is going to borrowers with subprime credit scores, measured here as having an Equifax Risk Score below 640, has been stable for the past three years and remains well below the high point in 2007.[4]

Figure 1: Year-to-Date Auto Loan Originations and Subprime Share



Source: Equifax Credit Trends 4.0 (June 2014); Note: Subprime is defined by an Equifax Risk Score < 640. Numbers reflect tradelines opened and reported through April of the origination year.

Lending in the heyday of the credit boom often greatly underweighted any consideration of credit worthiness outside of a credit score.

Furthermore, the lending landscape today is not the same as it was in 2007. Lending in the heyday of the credit boom often greatly underweighted any consideration of credit worthiness outside of a credit score. However, credit scores are predicated on lending underwriting standards being maintained as they were during the reference period used to create them – that is, they explicitly assume that lenders will verify the collateral, capital, and capacity of borrowers just as they always have. Lending has returned to the "good old days," both because lenders generally have a reduced appetite for risk and because regulatory scrutiny has increased. Specifically, in the subprime auto lending segment most lenders are now verifying incomes today on all loans. Given this, loans originated with a 620 credit score today are likely to perform very differently from loans originated with a 620 credit score in 2007, when the loans were likely granted without full underwriting.

1 Source: U.S. Bureau of Economic Analysis and Equifax. Uses seasonally adjusted, annual rate series.

2 Source: R.L. Polk.

3 Source: R.L. Polk, U.S. Bureau of Economic Analysis and Equifax. Auto sales total uses non-seasonally adjusted series.

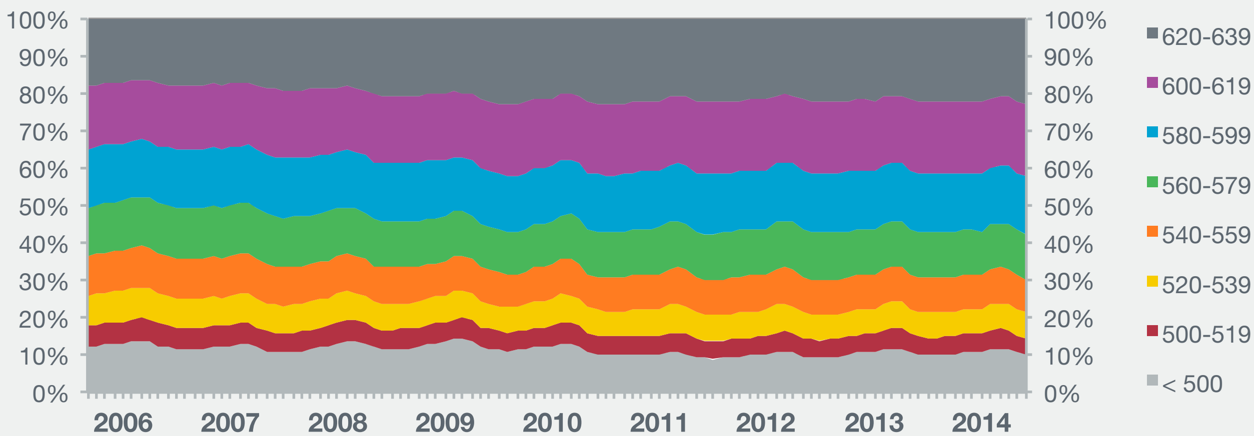
4 Note: We consider the year-to-date data because of the large seasonal patterns in auto sales and auto lending, and dislike adding in the additional noise that seasonal adjustments can generate during this short and tumultuous window of observation.

Lending has returned to the "good old days," both because lenders generally have a reduced appetite for risk and because regulatory scrutiny has increased.

Shifting Credit Landscape

Subprime lending has shifted toward lower risk within the spectrum. That is, conditional on being in the subprime range of scores, borrowers with new auto loans are more likely to be in the higher score bands of that range, as we show in Figure 2. In particular, the percentage of subprime loans originated to borrowers with a risk score above 600 has increased by nearly 24 percent since 2006, and by 3.1 percent since 2011. This suggests a tightening of subprime lending standards rather than a loosening.

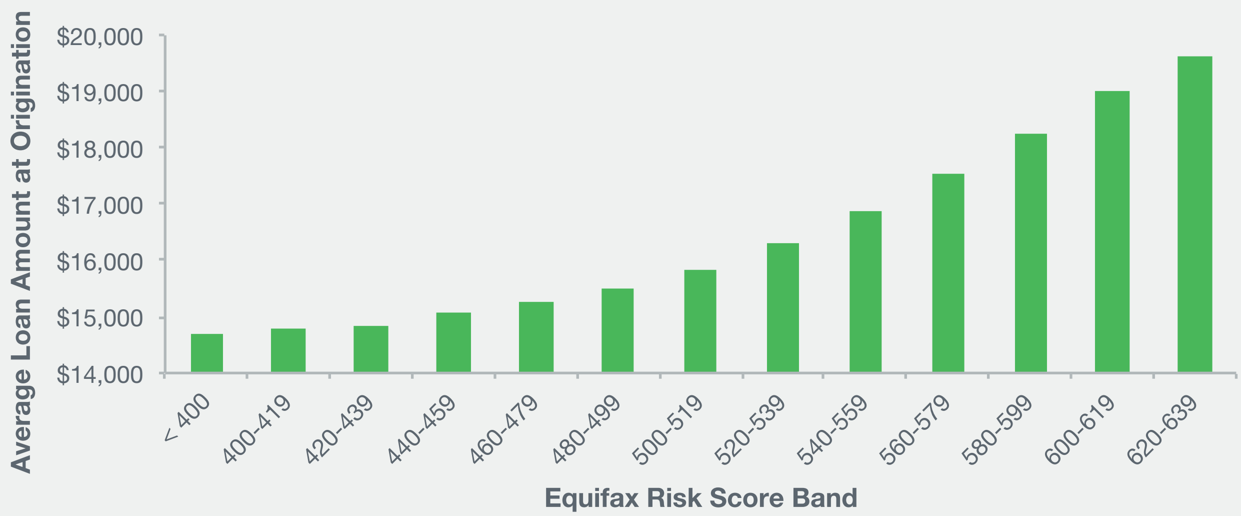
Figure 2: The Distribution of Subprime Auto Loan Originations by Credit Score Risk Band



Source: Equifax Credit Trends 4.0 (June 2014). Note: Subprime origination defined as a loan to a borrower with an Equifax Risk Score <640. Bands represent the percent of the number of subprime loans originated using a 3-month moving average.

The average loan balance at origination for a subprime credit score borrower has been rising, but this is not due to relaxed lending standards. The average loan size for recently originated loans by the borrower's Equifax Risk Score is shown in Figure 3. As a borrower's Equifax Risk Score increases (e.g. becomes less risky), so too does the average loan amount. This chart is representative of originations over the past several years as the loan amount–credit score relationship has been quite stable. Rather than giving larger loans to borrowers across subprime credit-score bands, lenders have been keeping loan sizes the same conditional on credit score but originating more loans to borrowers with less-risky scores as we showed in Figure 2. Thus average loan sizes have been increasing because relatively fewer high-risk borrowers with relatively smaller loan amounts are getting loans today.

Figure 3: Year-to-Date Subprime Loan Size for 2014 Vintage



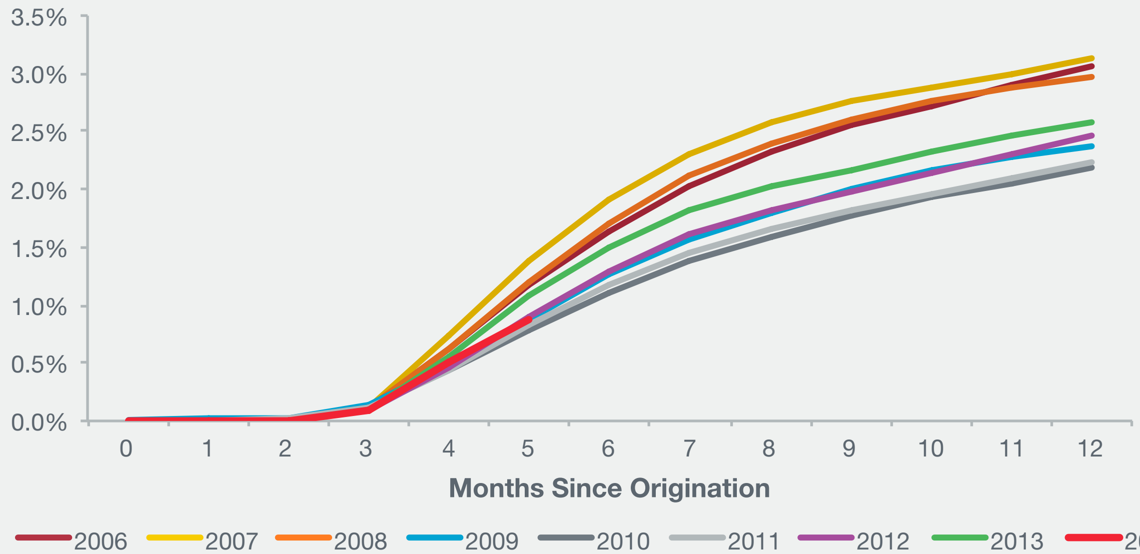
Source: Equifax Credit Trends 4.0 (June 2014); Note: Subprime is defined by an Equifax Risk Score < 640. Numbers reflect high credit limits of tradelines opened and reported through May of 2014.

All of this is academic however, without considering the most important metric – performance. If, as many are proclaiming, a bubble is forming, we would expect that recent vintages would exhibit decreased performance, showing higher delinquency rates or increased charge-offs. However, there is no evidence to suggest either is happening thus far.

Loans originated in 2010 and 2011 have the best early performance rates, but also were originated during the years of the most restrictive lending conditions.

Figure 4 shows the monthly 60+ days-past-due delinquency rate by number of months since origination for yearly vintages beginning in 2006. This chart shows a clear clustering of vintages — the 2006-2008 vintages as a group have the worst performance by a large margin. Loans originated in 2010 and 2011 have the best early performance rates, but also were originated during the years of the most restrictive lending conditions. As more credit has been extended to borrowers deeper in the subprime spectrum, delinquencies have increased, as would be expected. Importantly, 2014 vintage loans are showing very low rates of early delinquencies relative to recent years for the same age.

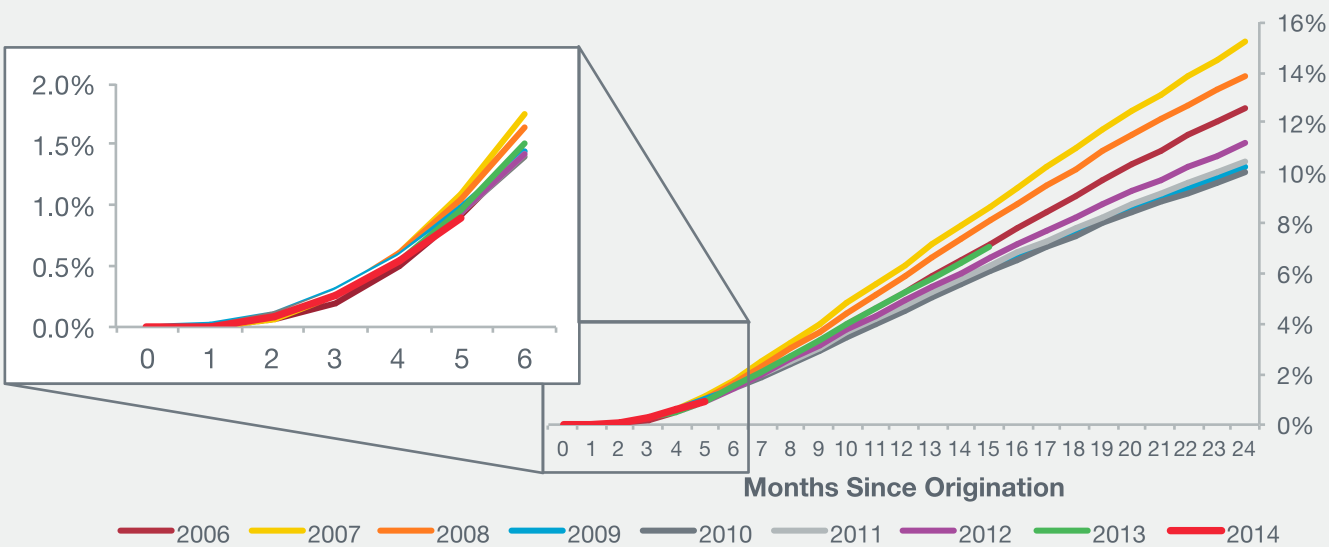
Figure 4: Subprime Auto Loans 60+ Days Past Due Rate by Time Since Origination by Vintage (%, NSA)



Source: Equifax: Credit Trends 4.0 (June 2014); Note: Subprime defined as loans to borrowers with origination credit score <640. Time 0 refers to the month of origination. Delinquency rate does not include write-offs or bankruptcies.

Figure 5 also shows subprime auto loan performance but now considers the cumulative write-off rate for the same vintages. The pattern again holds that originations made prior to the Great Recession have the worst performance, but here 2014 is showing the best performance over all earlier vintages through month five. While this is still early in the performance history for this vintage, the results thus far do not indicate that recently originated subprime auto loans are exhibiting decreased performance.

Figure 5: Subprime Auto Loans Cumulative Write-Off Rate by Time Since Origination by Vintage (%, NSA)



Source: Equifax: Credit Trends 4.0 (June 2014); Note: Subprime defined as loans to borrowers with origination credit score <640. Time 0 refers to the month of origination. Includes bankruptcy.

Given all of this information, we believe that while the subprime lending segment needs to be monitored carefully, the evidence does not support that there is a bubble forming in the auto lending space. It is also beneficial to consider than an unmet need is being satisfied. Assuming originations and loan performance in the space remain as they are today, this may benefit the overall economy, as well as the individual participants, in the long run.

DISCLAIMER

The opinions, estimates and forecasts presented here are for general information use only. This material is based on information that we consider to be reliable, but we do not represent that it is accurate or complete. No person should consider distribution of this material as making any representation or warranty with respect to such material and should not rely on it as such. Equifax does not assume any liability for any loss that may result from the reliance by any person on any such information or opinions. Such information and opinions are subject to change without notice. The opinions, estimates, forecasts, and other views published by Equifax's Economic Insights group represent the views of that group as of the date indicated and do not necessarily represent the views of Equifax or its management.

CONTACT US TODAY

For more information:
Meredith Griffani
Senior Director of Public Relations
meredith.griffani@equifax.com
equifax.com