BANKING & FINANCE

# Looking under the Hood: Current Conditions in Auto Lending

**Auto sales have been consistently strong since the recession, and vehicle loans have reflected that robust level of activity. But are some brake lights visible ahead? *Economy Matters*' "ViewPoint" examines trends in auto lending.**

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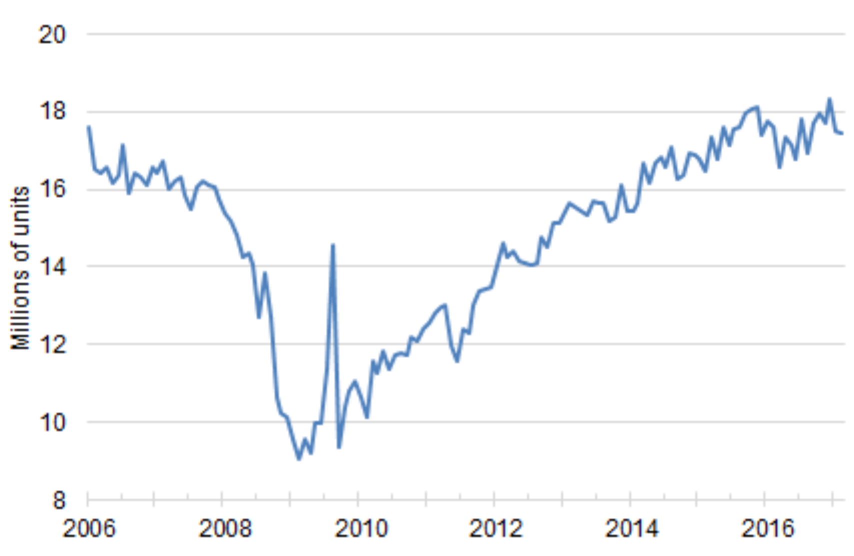
Vehicle sales and finance have been positive drivers for consumer spending during the last four years. During the financial crisis, U.S. auto sales declined sharply, dropping to a low point of just over nine million in February 2009. Once the economy began to stabilize in 2011, pent-up buyer demand led to increased auto sales.

Both sales and prices of autos have reached record highs. In 2015 and 2016, sales reached an annualized level of just over 18 million autos, nearly double the level from the depths of the crisis (see chart 1).

**Chart 1**
**Auto and Light Truck Sales**




Note: Data are seasonally adjusted.
Source: U.S. Bureau of Economic Analysis, Risk Analysis Unit

Forecasts for 2017 reflect flat or declining sales. In fact, increased prices on new and used cars, as well as a shift in consumer demand away from sedans to sport utility vehicles (SUVs), have pushed new car inventory levels to the point to where some manufacturers are reducing production and offering larger incentives to buyers.

**Trends in auto finance**

As noted above, good times for car sales pushed prices up dramatically. The average transaction price for a new car in February 2017 was approximately $34,352, according to Kelley Blue Book. At the same time, used car prices rose due to tighter inventories. Although trending downward in 2016, prices for previously owned cars have approached the cost of new cars, increasing the need for financing. More than 85 percent of new car buyers and more than half of used car buyers use some type of financing.

On a national basis, the number of auto loans now exceeds the number of mortgages. According to a report by Experian-Oliver Wyman Market Intelligence, outstanding total auto loan balances reached a record high of $1.07 trillion as of December 31, 2016. The average new auto loan amount now exceeds $30,000, with used car amounts moving close to $20,000. Nearly three-quarters of new auto loans have terms longer than 60 months, and 59 percent of used auto loan terms exceed 60 months.

**Car loans boost lenders' balance sheets**

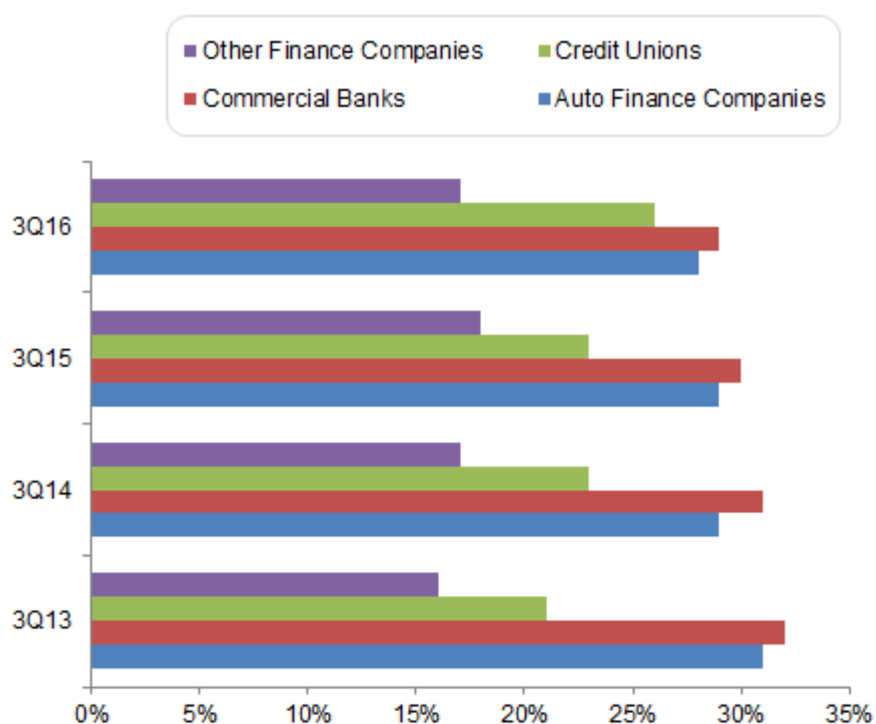
Coming out of the crisis, the auto portfolio was one of the only consumer portfolios in which banks were able to achieve growth. At one point, auto loans represented just over 40 percent of outstanding consumer loans on community banks' balance sheets. Of the four primary groups of auto lenders—banks, credit unions, captive auto finance companies, and other finance companies—banks have typically provided approximately a third of total auto financing ahead of credit unions and captive auto financing companies, followed by other finance companies. (A captive finance company, or "captive," is a subsidiary that provides financing only to customers purchasing the parent company's product.)

As of December 31, 2016, banks and credit unions together represented roughly 50 percent of the overall outstanding balance of originations for new and used autos. According to call report data, commercial banks had more than $400 billion in auto loans on their balance sheets as of the fourth quarter of 2016. The reemergence of captives and a greater push by credit unions have quickly reduced the margins on auto lending portfolios. In response to competitive pressure, loan-to-value (LTV) ratios have increased and maturities have been extended.

With margins narrowing and underwriting standards declining, banks have pulled back on auto lending. In the Sixth Federal Reserve District, auto loan growth turned negative in the third quarter of 2016. In the January 2017 Senior Loan Officer Opinion Survey, some banks reported decreased demand for auto loans in the fourth quarter as well as a tightening of lending standards. A significant fraction expects to see deterioration in asset quality in 2017, and a modest fraction expects terms to tighten further. Some banks have started moving their portfolios off the balance sheet and into asset-backed securitizations (ABS).

As banks have pulled back, credit unions and captives have gained market share. While banks' market share of total financing declined by 2.7 percent in 2016, captives' market share increased by 0.6 percent and credit unions' market share increased by 1.1 percent (see chart 2).

**Chart 2**
**Auto Lender Origination Trends**




Source: Experian Consumer Credit Trends Report

Other finance companies' market share increased by 1.2 percent. Although the market share of other finance companies has increased, these companies appear to have put greater emphasis on subprime customers. Some subprime auto loan issuers are allowing higher LTVs, longer loan terms, and higher collateral losses in a bid to maintain margins. For example, in the fourth quarter of 2016, Experian reported that the term for loans to subprime borrowers averages six years on new cars, compared to 5.5 years for customers deemed less risky. However, Transunion's studies of loans originated between 2010 and 2012 have found that auto loans originated with longer terms are performing poorly.

**Delinquency trends edge up**

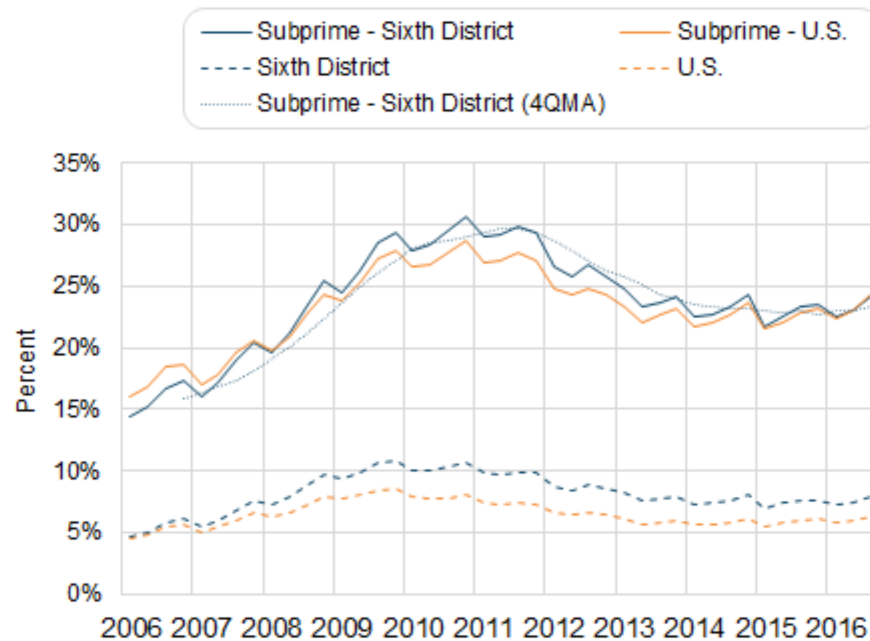
Delinquencies crept up slightly through the third quarter of 2016. Total auto loan delinquency reached an estimated 6.4 percent, up slightly year over year but 220 basis points below the height reached during the financial crisis. Data from Transunion show that during the crisis, the rate of auto loans 60 days or more delinquent peaked in the fourth quarter of 2008 at 1.59 percent. (For comparison, the rate of auto loans 60 days or more delinquent during the fourth quarter between 2007 and 2013 averaged 1.29

percent.) According to data from Experian, total market delinquency rates for loans 60 days or more past due has remained below 1 percent since 2013. Data also show that although 30-day delinquency rates for auto loans are relatively stable, 60-day delinquencies have increased slightly.

To date, the deterioration appears geographically focused, and aggregate levels have risen moderately. Delinquency rates are highest along the Sun Belt, particularly in two southeastern states—Louisiana and Mississippi—according to Equifax. Fluctuating energy prices in particular have affected Louisiana.

Auto loans to subprime borrowers are deteriorating more rapidly than loans made to other borrowers (see chart 3). Loan originators report that compared to borrowers just after the crisis, loans to borrowers with the same credit score today are performing worse. Subprime auto delinquencies were at 25.1 percent as of the fourth quarter of 2016. Though this was up 185 basis points from a year earlier, the peak delinquency was 28.8 percent in late 2010. Also, new lenders with weaker underwriting standards that joined the auto lending market following the financial crisis have experienced more deterioration in subprime loan performance.

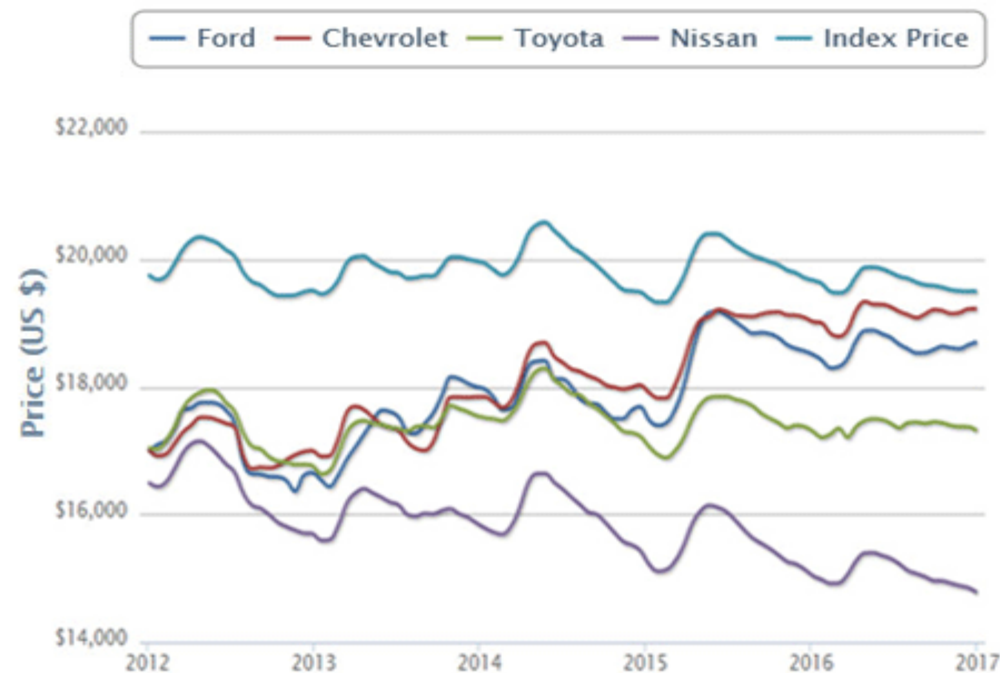
**Chart 3**
**Auto Loan Delinquencies**




Note: Loan balances and number of consumers are estimates for the entire U.S. population based on a 5 percent random sample. Balances are adjusted, taking into consideration the existence of joint accounts. Data are not seasonally adjusted.
Source: FRBNY Consumer Credit Panel; Risk Analysis Unit/Federal Reserve Bank of Atlanta

**Collateral values become significant**
Lenders use vehicles as collateral for auto loans with the expectation that, in the event of a default, they could recover at least some of the loan amount by selling the vehicle. However, auto loans might not serve as collateral as well as lenders generally hope. According to a recent report from Edmunds, consumers are increasingly trading in cars with negative equity, with about a quarter of trade-ins carrying negative equity. Generally, used car prices began moving down during the past year (see chart 4).

Used Car Prices Over Time




Source: https://www.cargurus.com/cars/price-trends

At the same time, Experian Automotive recently reported that used car loans have risen to an average of $19,329 as of the fourth quarter of 2016, implying that most used car buyers are simply rolling their negative equity into their new loans. Between 15 percent and 20 percent of outstanding balances on newly originated auto loans reflect negative equity from prior car loans. However, payments on the new loan remain virtually unchanged, which raises questions about underwriting at a time when lending remains very competitive.

**Should banks tap the brakes?**

Although vehicle sales are still substantially higher than during the financial crisis, it is expected that sales will remain flat or possibly decline in 2017. Financing is critical to maintaining sales and has been readily available, even for those with weak credit histories. With inventories building, loan terms remain very generous, pushing out beyond seven years in some cases.

Though delinquencies on car loans remain low by historical standards, this seemingly modest level may mask a troubling trend for subprime borrowers. Problems are becoming apparent in some geographic areas and in the subprime segment. As more customers roll existing auto loans into new vehicle purchases, the collateral value of vehicles may not adequately support new loans. Consequently, banks need to closely monitor their portfolios and develop a clear understanding of current collateral values. A downturn in the economy could quickly lead to increasing defaults and repossessions. However, banks may be unable recoup as much collateral value as expected at origination.

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