BANKING & FINANCE

Are Credit Conditions for Southeastern Auto Lending Downshifting?

May 29, 2018

Recently, the auto industry announced that vehicle sales for 2017 were slightly lower than 2016, ending a record seven-year period of increasing sales. For several years after the financial crisis, auto sales and financing helped drive the growth of consumer loan portfolios. As demand from prime borrowers waned, lenders sought to maintain loan balances by turning to customers with lower credit scores.

Subprime lending provides financing to borrowers with less-than-stellar credit ratings and carries higher interest rates to cover the increased risk. As defined by Experian's Vantage Score 3.0, subprime borrowers have credit scores ranging between 300 and 600. In 2015, nearly 40 percent of auto loans went to subprime borrowers and were provided primarily by auto finance companies—not banks.

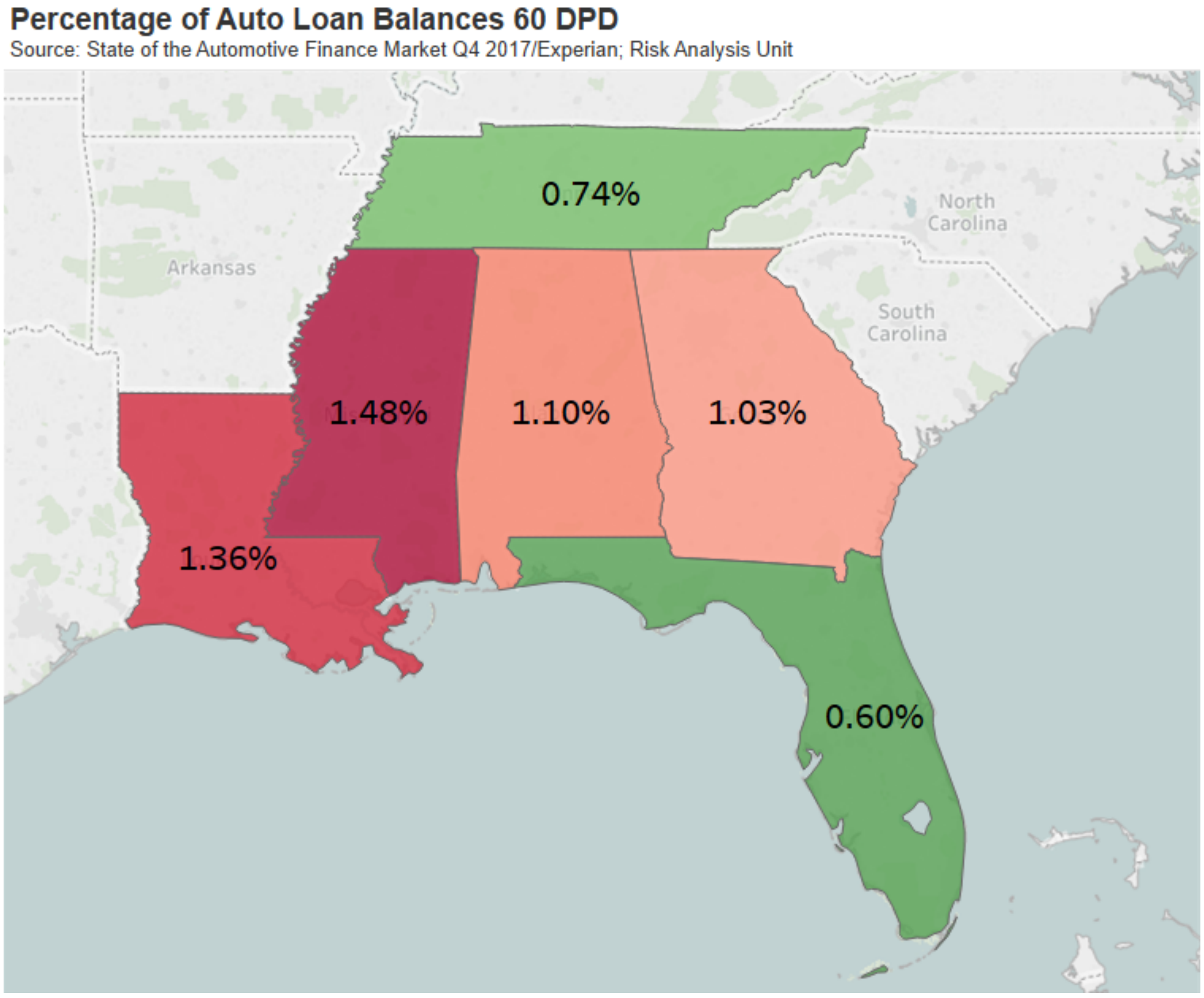
Perhaps not surprisingly, there are indications that performance on these subprime loans is weakening. The rideshare company Uber recently announced that it was backing away from its subprime car-leasing division and selling the portfolio amid concerns about its performance. Uber isn't the only company that's having trouble with subprime lending. In its most recent quarterly update, the consumer credit company Experian noted a broad increase in auto delinquencies. However, the level of delinquency remains far below historical levels.

In a recent discussion of auto trends, the credit-reporting agency Transunion noted some tightening in underwriting among customers with lower credit scores, including subprime, near-prime, and prime. These borrowers—especially subprime ones—continue to have access to credit, but their loan balance growth has been slower than that of borrowers with good credit. Banks appear to be focusing on customers with better credit quality and are willing to cede overall market share to other lenders. In addition, for auto loans in particular, banks have suggested that concern over declining collateral values is an important reason for tightening standards. As of December 31, 2017, year-over-year growth in the auto portfolio was approximately 3 percent, the lowest year-over-year growth rate in more than five years.

Performance moves to a low gear

Nationally, delinquency rates on vehicle loans remain low by historical standards. Overall, vehicle loan delinquencies declined through the fourth quarter of 2017. Yet vehicle loan performance by all types of lenders is mixed across Sixth Federal Reserve District states.

Florida is among the top states in terms of decline in loans 60 days or more past due, dropping 26 basis points from the prior

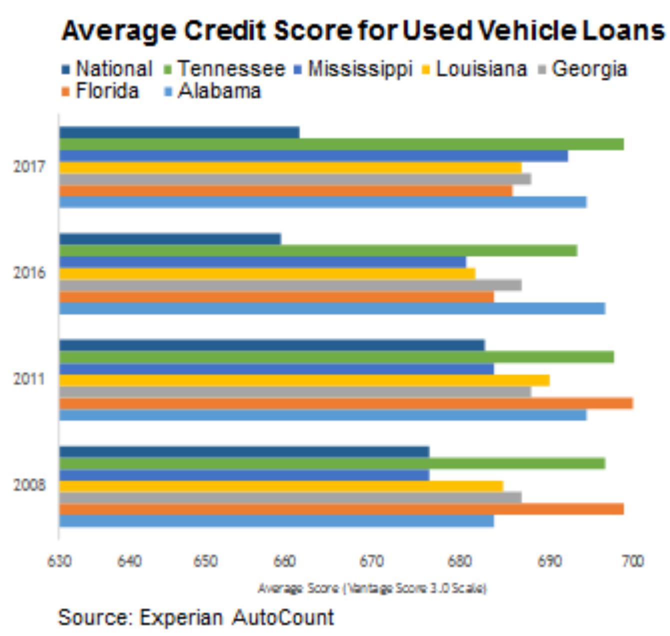


quarter to 0.60 percent as of December 31, 2017 (see the map). The decline partly reflects a slowdown in collections and credit reporting, the result of that state's natural disasters.

As conditions return to normal, conditions in Florida may begin to resemble those in other southeastern states. Georgia also experienced a decline, though it was less than 1 basis point from the prior quarter. Meanwhile, Mississippi and Louisiana saw loans 60 days or more past due rise by 5 basis points, putting both states among the country's top 10 in that category. Alabama had an increase in delinquency of 3 basis points. Tennessee had an increase of only 1 basis point. In terms of new delinquencies (loans past due between 30 and 59 days), Mississippi and Louisiana's rates lead the nation. Mississippi is the only state with a delinquency
rate above 4 percent.

Underwriting trends evolving

Given the increase in vehicle delinquencies across much of the Southeast, we can use one of Experian's tools, AutoCount, to analyze shifts in underwriting since the financial crisis and to better understand potential credit problems in the auto portfolio. Since the financial crisis, firms have increased their vehicle loan production, with banks in several states doubling the number of loans originated in 2017 compared with 2008. For the purposes of this article, the reviewed loans were originated in December 2017, December 2016, December 2011, and December 2008, and factors analyzed included credit scores, loan terms, average price, and average monthly payments.

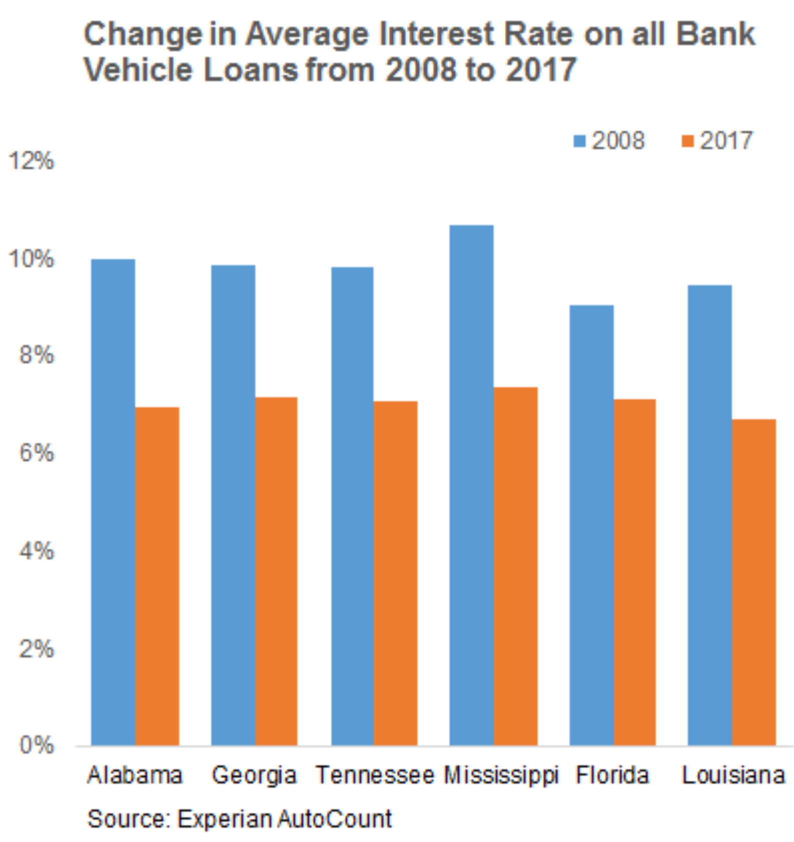


Despite the increase in originations, credit scores failed to shift upward the same way scores shifted in mortgage underwriting. For example, average credit scores for all vehicle loans in Alabama have remained basically unchanged since 2008, ranging between 691 and 700 under the Vantage 3.0 scoring system (see the chart). Credit scores were highest in 2011. Although overall average credit scores remain fairly flat, the general trend is downward in new vehicle loans and upward in used vehicle loans. None of the banks in the Atlanta Fed's district had average credit scores in the subprime range, and most of the large banks operating in the state had credit scores above 700.

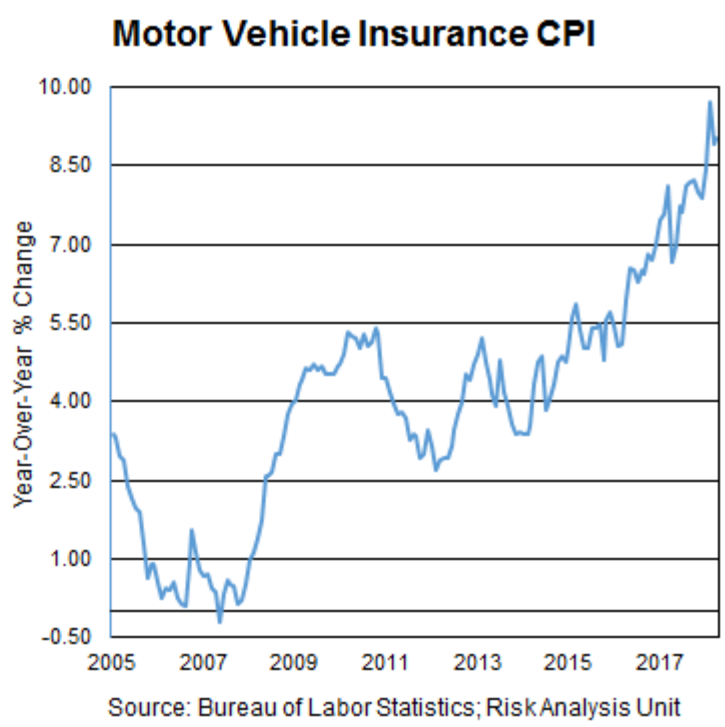
Nationally, borrowers' average credit scores for new vehicle loans (not just banks but also nonbank lenders) increased to 713 from 711 in the prior year, the highest level seen since 2013. Among Sixth District states, Georgia had the lowest average credit score—696—for new vehicles, and Tennessee had the highest average score at 708. Credit scores for new vehicles in Florida have shifted the most, dropping from 728 in 2008 to 701 in 2017.

Credit scores for used vehicles are also generally lower. Demand for vehicles increased significantly in the fourth quarter as consumers looked to replace vehicles damaged by the hurricanes that struck Florida in September 2017. Nationally, the average credit score for a used vehicle was 617 in December 2017, according to Experian. In Mississippi, the average used vehicle score was 685, an improvement over the average score of 670 in 2008, barely into the prime category.

At the national level, vehicle loans made by all lenders reached record highs for both average new and used loan amounts. Within Sixth District states, the average amount financed has crept up more than 30 percent since 2008. In Louisiana, the average amount financed for new vehicles has reached $30,000, the highest among Sixth District states. By comparison, the median annual household income in Louisiana is $45,652, according to the U.S. Census Bureau. This comparison appears consistent with reports by Moody's that the growth in the average amount financed for a new car has far exceeded national median income growth in recent years. Average used vehicle loan amounts now exceed $20,000 in all six states of the Atlanta Fed's District.



As Experian has noted, the gap between new and used vehicle loan average amounts is wider than ever, pushing more borrowers with good credit to consider used vehicles. Low interest rates have kept monthly payments from increasing significantly (for new and used vehicle loans) despite higher financed amounts. Nationally, monthly payments on new vehicles increased to $515 at the end of 2017, a record high. All of the states in the Sixth District had higher new vehicle monthly payments than the national average, with Louisiana the highest at $558.



For used vehicles, the national average for monthly payments is $371. Among Sixth District states, only Tennessee had monthly payments close to that amount, at $374. All other states in the Sixth District had higher payments than the national average. In Alabama, average interest rates on vehicle loans declined by more than 300 basis points from 2008 to 2017, with rates on used car loans decreasing more markedly (see chart).

In several states, the average interest rate on used vehicles has fallen from around 11 percent to 7.5 percent. Despite declining interest rates that have made vehicle payments more affordable, insurance costs have skyrocketed since the advent of the smartphone (and the resulting increase in distracted-driving accidents), wiping out some of the savings (see the chart). Two states in the Sixth District, Louisiana and Florida, rank among the top ten most expensive states to insure a vehicle, according to a study by Insure.com.

Data on loan-to-value (LTV) ratios are more limited. However, based on available data, LTV ratios on vehicles have remained stable for new vehicles but have steadily climbed for used vehicles since 2011. Edmunds.com reported that in 2017, nearly a third of cars traded nationally were worth less than the loans financing them. By comparison, a quarter of loans were underwater in 2007, when the financial crisis began. For example, in Georgia, the average LTV ratio for a used vehicle was 127 percent in 2011. By 2017, the ratio had risen to 133 percent. Loans with the highest LTV ratios tended to go to customers with subprime credit scores.

At the same time, the average length of a vehicle loan made by all lenders has increased. On a national basis for both new and used vehicles, the average loan term is more than five years, and new vehicle loan terms are reaching 69 months. Although the average term has increased, banks are generally extending such terms only to customers with good credit scores. In the Sixth District, new vehicle loan terms made in 2017 are now one month shy of six years, or 71 months, basically unchanged from 2016. The average credit score of borrowers receiving loans with terms of 60 to 72 months is 688. Loan terms in the Sixth District for used vehicles are nearly the same as those for new vehicles: 67 months as opposed to 71 months.

A caution flag down the road?

Despite recent tighter underwriting, when the economic cycle slows, banks in the Sixth District might take larger losses on loans because of higher LTV ratios and longer loan terms that extend the paying of principal. Americans love their cars, but they also don't want them to overheat—that also goes for the auto lending market.

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