

Subprime Securitization Hits the Car Lot

Are fears of a “bubble” in auto lending overstated?

By Jessie Romero

The car dealers deliberately inflated borrowers' incomes — sometimes without the borrowers' knowledge — to ensure the loan applications would be approved and they'd make the sale. The lender knew the applications were fraudulent and the borrowers were likely to default, but it didn't care because it could package the loans into securities and sell them off to investors. At least, that's the version of events described in an action brought by the attorneys general of Massachusetts and Delaware against Santander Consumer USA, a subsidiary of the Spanish bank Banco Santander that specializes in auto financing. In March 2017, Santander agreed to a \$26 million settlement that includes \$19 million in relief to more than 2,000 borrowers.

To many observers, Santander's alleged lending practices look alarmingly similar to those that contributed to the housing boom and bust a decade ago, lending weight to broader concerns that rising delinquencies indicate an auto lending “bubble” is about to burst. “Auto Loan Fraud Soars in a Parallel to the Housing Bubble,” proclaimed one headline. “Are Car Loans Driving Us Towards the Next Financial Crash?” asked another.

Regulators and policymakers also have expressed unease. In the fall of 2016, for example, the Office of the Comptroller of the Currency warned that auto lending risk was increasing and that some banks did not have sufficient risk management policies in place. Fed Gov. Lael Brainard pointed to subprime auto lending as an area of concern in a May 2017 speech; her concerns were repeated — and amplified — the next month in a speech by then-Gov. Stanley Fischer.

While it's not obvious whether the increase in subprime auto lending is a significant departure from past cycles, it has raised eyebrows coming so soon after the mortgage crisis — especially as delinquencies have begun to rise. In addition, an increasing share of those loans have been securitized and spread through the financial system, much like mortgages before the housing bust. Still, even if the auto finance industry were poised for a fall, the effects on the financial system could be limited — although the auto industry itself might take a hit.

Buy Now, Pay Later

In 1919, General Motors (GM) had a problem. The innovation of the assembly line a half-dozen years earlier by Henry Ford had made it cheaper and easier to build cars, but that meant GM needed its dealers to buy in bulk — and the dealers needed people to buy more cars. The solution was credit, but banks were leery of making loans for a relatively new invention they didn't know how to value. (Around the same time, the Federal Reserve warned banks against financing “automobiles that are used for pleasure.”) So GM launched its own financing company, the General Motors Acceptance Corporation (GMAC), to enable dealers to stock more inventory and consumers to buy more cars. Other car manufacturers eventually followed suit, and today, every major auto manufacturer has its own “captive” finance company.

The next major innovation in auto finance arrived half a century later. Banks and credit unions had entered the market by this point, but loans generally were only available to borrowers with strong credit histories. That began to change in 1972, when Detroit businessman Don Foss founded Credit Acceptance, an independent finance company, to finance sales at his network of used car dealerships. Credit Acceptance was the first company to specialize in auto loans to borrowers with limited or poor credit history, known today as “subprime” loans, and its success spawned numerous competitors.

One of those was Ugly Duckling, an Arizona-based used car dealership that expanded quickly during the 1990s. (The company is now known as DriveTime.) Ugly Duckling mainstreamed the “buy here, pay here,” or BHPH, dealership format, in which the dealer is also the lender, typically to borrowers with very poor or no credit. BHPH dealerships often require borrowers to make their payments in person, hence the name; interest rates may be as high as 30 percent.

Today, roughly 86 percent of all new cars in the United States are purchased via financing; about two-thirds of those transactions are loans and one-third are leases. Captives and banks issue the majority of new car loans and leases; as of the second quarter of 2017, they had 53 percent

and 29 percent market share, respectively. Credit unions currently finance around 13 percent of new cars, with the remainder financed by independent finance companies, BHPH dealerships, and other lenders. In the used car market, about 55 percent of cars are financed, the vast majority via loans. At present, banks make 35 percent of used car loans, slightly more than their share of the new car market. Credit unions, independent finance companies, and BHPH dealerships play a much larger role in the used car market than they do in the new car market, with 27 percent, 17 percent, and 13 percent market share, respectively.

While a consumer can work directly with a lender and shop for a car with a pre-approval in hand, about 80 percent of car financing is arranged through dealerships. The dealer sends the loan application to a number of lenders with whom it has a relationship, and a lender who is willing to make the loan will respond with a “buy” rate. The dealer then has some discretion to either lower the rate and absorb the difference in order to make the sale, or to charge the purchaser a higher rate and keep the difference as compensation for serving as middleman.

Motor Trends

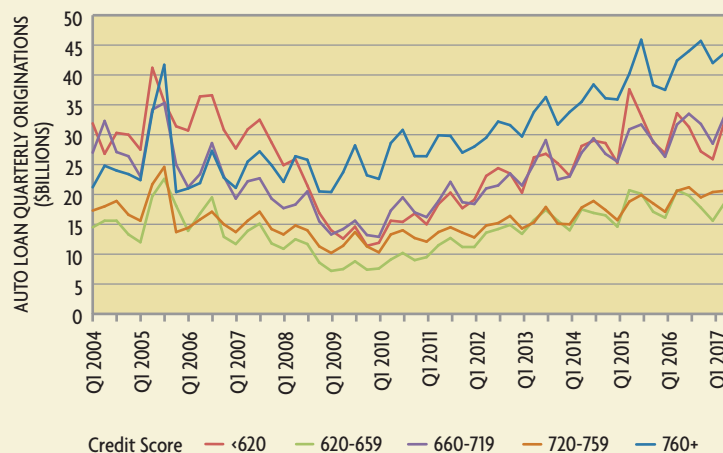
Household auto debt fell during the Great Recession, as did all types of household debt excepting student loans, but has rebounded more quickly than other types. Between the second quarter of 2010 and the second quarter of 2017, outstanding auto debt increased nearly 70 percent, from \$700 billion to \$1.2 trillion, according to the New York Fed’s Quarterly Report on Household Debt and Credit. In contrast, credit card debt increased just 5 percent, from \$7.4 billion to \$7.8 billion. Auto loans are now the third-largest form of debt behind mortgages (\$8.7 trillion) and student loans (\$1.3 trillion).

Subprime auto debt contracted sharply during the Great Recession but growth resumed soon after. While there is no legal definition of prime or subprime, a credit score of 620 is generally the cutoff in auto finance; credit scores range from 300-850. Between 2010 and 2015, average quarterly originations to subprime borrowers more than doubled, from \$15 billion per quarter to \$31 billion per quarter (albeit still below the high of \$34 billion per quarter in 2005), according to New York Fed data.

With the mortgage crisis fresh in many people’s memories, the increase in subprime auto lending garnered considerable attention. But the growth was comparable to growth in other credit categories. Loans to borrowers with a credit score between 660 and 719 increased from an average of \$17 billion per quarter to \$31 billion per quarter. Loans to “super prime” borrowers, those with a credit score above 760, grew less in percentage terms but have surpassed the pre-recession peak. (See chart.) “The subprime pipe was turned off after the financial crisis,” says Melinda Zabritski, the senior director for automotive finance solutions at Experian. “When the pipe got turned back on, the increase looked dramatic, but we were coming out of a trough.”

Subprime Revs Up

The return of subprime auto lending has garnered considerable attention



SOURCE: Federal Reserve Bank of New York, “Quarterly Report on Household Debt and Credit,” Second Quarter 2017

Some of the growth was fueled by competition, particularly among captives and independent finance companies, which have originated about 75 percent of outstanding subprime loans. As the demand for auto loans grew during the recovery, new finance companies entered the market and existing finance companies sought to expand. In an effort to reach new customers, these companies “started buying a little ‘deeper’ and taking on more subprime borrowers,” says Zabritski. Even GM, which had sold a majority stake in GMAC to a private equity firm in 2006, got back into the financing game by purchasing subprime specialist AmeriCredit in 2010.

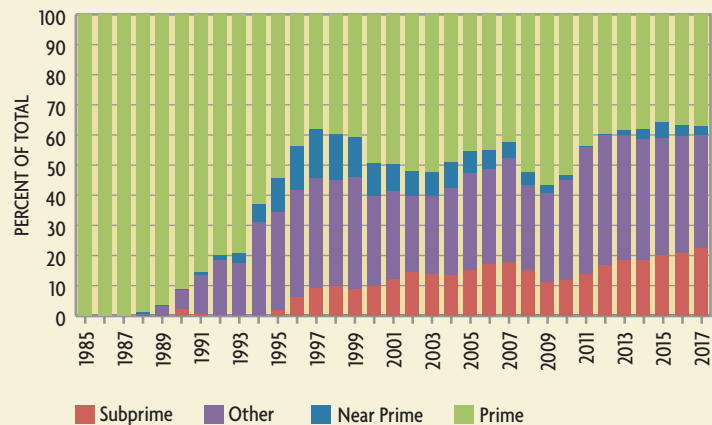
Subprime auto lending might already have peaked for now, however. Beginning in 2016, bankers reported tightening auto lending standards in the Fed’s Senior Loan Officer Opinion Survey, and even some traditional subprime specialists have taken steps to tighten credit. Overall, average credit scores increased by four points for both new and used cars between the second quarter of 2016 and the second quarter of 2017, according to Experian. Average quarterly subprime originations also decreased in 2016, for the first time since 2009, to \$30 billion per quarter.

The retreat is potentially a response to rising delinquencies. Between 2012 and 2016, average annual subprime delinquencies increased from 2.5 percent to 4.3 percent — a higher rate than in 2008, according to S&P Global Ratings. Researchers at the New York Fed calculated that the share of subprime loans that were 90 days or more delinquent increased nearly 40 percent from the beginning of 2013 to the third quarter of 2016, for a total of about 6 million consumers.

One reason for the rise in subprime delinquencies, despite improvements in the economy and labor markets overall, may be a change in the composition of subprime borrowers. The foreclosure crisis affected both subprime and prime borrowers, so consumers who may otherwise

Subprime Securitization

As a share of all auto ABS, subprime has surpassed its pre-crisis peak



NOTE: "Other" includes ABS backed by leases, fleet sales, rentals, dealer floorplan loans, and motorcycle/RV loans. Data for 2017 are from the third quarter.

SOURCE: Securities Industry and Financial Markets Association

have been low risk could have seen their scores drop to subprime levels. Many of those borrowers' credit scores have since recovered, however. (See "The Missing Boomerang Buyers," *Econ Focus*, First Quarter 2017.) As a result, the remaining pool of subprime borrowers may be riskier.

It's also possible that increased competition led lenders to lower their underwriting standards in other ways, such as not requiring proof of income. In at least one batch of loans, for example, Santander Consumer verified just 8 percent of borrowers' incomes. Lenders also have been increasing the length of loans. In 2002, 36 percent of subprime loans had an original loan term longer than 60 months. In 2016, more than 83 percent had a term longer than 60 months. Some lenders even offer 84-month — seven-year — car loans. These loans are attractive to some buyers because they offer a lower monthly payment, but they are also much more likely to end in default.

Securitizing Subprime

Like other types of loans, including student loans and credit card receivables, auto loans can be packaged into securities and sold to investors. These "asset-backed securities," or ABS, provide the lender with the cash (and an additional incentive) to make more loans. ABS made up of auto loans — "auto ABS" for short — are mostly issued by independent and captive finance companies.

Auto loan securitization increased rapidly in the early 2000s, as did securitization in general. Between 2000 and 2005, the annual issuance of auto ABS increased from \$70 billion to \$106 billion; total ABS (excluding collateralized debt obligations, which comprise multiple securities types, including mortgages) grew from \$185 billion to \$280 billion. Issuance of auto ABS contracted sharply during the Great Recession, but afterward, between 2010 and 2015, it grew from \$58 billion per year to \$96 billion. Currently, auto ABS makes up about 45 percent of ABS

issuance, according to data from the Securities Industry and Financial Markets Association (SIFMA).

An increasing share of those ABS are backed by subprime loans. In 2009 — the financial crisis trough — subprime loans accounted for just 11 percent of auto ABS. As of the third quarter of 2017, the share had more than doubled, to 22.5 percent — 4.5 percentage points higher than the pre-recession peak. (See chart.) Moreover, many of those loans were made to the riskiest borrowers; the share of securitized subprime loans considered "deep subprime" — to borrowers with a credit score in the mid-500s or below — soared from 5 percent in 2010 to 33 percent in 2017.

The increase in subprime and deep-subprime securitization has continued despite worsening performance. Subprime securitization net loss rates have increased steadily since 2010; in June of that year, the average net loss rate was 3.5 percent, according to market analytics firm S&P Global. In June 2017, the rate was 6.2 percent. The cumulative net loss rate — total losses since the security was issued — also has increased for successively later "vintages" of security issuances.

Lower performance in part reflects more loans being made to borrowers with lower credit scores and their usually higher delinquency rates; if average credit scores continue to improve, performance might improve as well. But higher loss rates also reflect lower recovery rates, meaning that lenders are recouping less from the sale of repossessed cars. Longer loan terms bear some of the blame, because they make it more likely the loan's outstanding balance exceeds the car's value if the buyer defaults in the early years of the loan. In addition, record-high rates of vehicle leasing in recent years have swelled the number of used cars on the market, lowering the value of repossessed collateral. If those trends continue, they might be a drag on subprime ABS performance even if delinquency rates stabilize or go down.

Toil and Trouble?

Higher loss rates don't necessarily translate into higher losses for investors, however. Some amount of loss is built into issuers' projections, and subprime issuers typically offer "credit enhancements," such as establishing a reserve fund or holding extra collateral, to cover those expected losses. And since the Securities and Exchange Commission issued a rule in 2014 requiring ABS issuers to release loan-level detail about their bond packages, potential investors have substantial information with which to evaluate the adequacy of those enhancements. Problems are more likely to arise when the actual losses exceed the expected losses.

That's what happened in the mortgage market a decade ago; in hindsight, market participants underpriced the amount of risk present in mortgage-backed securities (MBS), perhaps in part because they had some expectation the government would step in to protect them. There's little evidence of a similar expectation in auto lending; although the U.S. Treasury purchased a large stake in

GMAC in 2008, the move was widely regarded as an attempt to protect auto manufacturers rather than lenders or investors. All else equal, the absence of government support, explicit or implicit, would make the auto lending industry more responsive to risk.

Other factors could contribute to lenders and investors underpricing risk, however. For example, a car is a relatively easy asset to repossess compared to, say, a home. Laws vary from state to state, but in general, lenders are allowed to repossess a vehicle as soon as the borrower is in default without providing any prior notice. Actually towing the vehicle takes just minutes, and some lenders and car dealers even install so-called “kill switches” to prevent a car from starting if the borrower misses a payment. In contrast, in many states, a home foreclosure requires judicial action; even in nonjudicial states, the process can take months or even more than a year to complete.

Cars depreciate rapidly, which means there’s likely to be a gap between what the borrower owes and what the lender can recoup. But in nearly every state, lenders are allowed to sue borrowers for the difference. A lender who obtains such a “deficiency judgment” is able to garnish a borrower’s wages or seize other assets. Some states also allow mortgage lenders to sue foreclosed borrowers, but there are greater restrictions on obtaining a judgment than in auto lending.

Even if subprime auto ABS performance does deteriorate beyond current expectations, there are reasons to think it’s unlikely the effects would spill beyond the auto finance sector into the broader financial system.

“People who say, ‘This is just like the subprime mortgage crisis!’ are missing the boat,” says Christopher Killian, managing director and head of the securitization group at SIFMA. First, auto loans are a much smaller portion of consumer debt than mortgages: \$1.2 trillion versus \$8.7 trillion in outstanding mortgage balances. And the volume of auto ABS is dwarfed by the volume of MBS: Mortgage-backed securities in the United States total more than \$9.1 trillion (including both residential and commercial), compared to \$201 billion in outstanding auto-loan-backed securities. Perhaps most important, Killian notes, auto ABS aren’t turned into collateralized debt obligations, the highly complex securities that helped transmit MBS losses throughout the entire system.

“Let’s imagine the subprime auto market craters,” Killian says. “There will be losses, but there won’t be cascading losses.”

History also offers some reassurance; this is not the first time investors have been enamored of subprime auto loans. In the early 1990s, the securitization market contributed to hundreds of new subprime lenders opening their doors; between 1991 and 1994, there were more than 20 initial public offerings. Just a few years later, a combination of accounting irregularities, overleverage, and fraud had contributed to massive stock price declines and numerous bankruptcies. Stockholders and investors lost money, but the effects on the broader financial system were nil.

The Effects on Detroit

Still, past performance is no guarantee of future results. As Fischer noted in his June speech, the potential for subprime auto lending to cause broader financial distress seems moderate at first glance. But, he cautioned, “[O]ne should remember that pre-crisis subprime mortgage loans were dismissed as a stability risk... and not take excessive confidence.”

The industry most likely to feel the pain from a decline in subprime lending is the auto industry itself, which accounts for about 3 percent of U.S. GDP and supports nearly 4 percent of private employment. Vehicle sales have been a bright spot during the relatively tepid recovery from the Great Recession, doubling from a nadir of 9 million sold per month in early 2009 to about 18 million per month at the end of 2016. But during the first eight months of 2017, monthly sales fell by about 2 million and many manufacturers began cutting jobs. (Vehicle sales spiked in September of 2017, in part because consumers were replacing hurricane-damaged cars.) Numerous factors influence vehicle sales, including energy prices and trade policy. But many observers noted the correlation between the decline in sales and tightening credit conditions.

The availability of credit played a large role in the drop in vehicle purchases during the Great Recession, according to a 2017 article in the *Quarterly Journal of Economics* by Efraim Benmelech of Northwestern University, Ralf Meisenzahl of the Federal Reserve, and Rodney Ramcharan of the University of Southern California. The authors concluded that lenders’ lack of liquidity accounted for nearly one-third of the decline in auto sales in 2009.

Barring other developments, it’s doubtful a pullback from subprime auto lending and securitization would result in an auto credit crunch as extreme as that experienced during the financial crisis. Still, manufacturers are keeping their fingers crossed the subprime pipe stays open. **EF**

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