



LENDER SOLUTIONS

DATA DRIVING INNOVATIONSM



Understanding The Importance Of Regularly Monitoring Collateral Risk Levels

Auto lenders have had a spike in volume since the recession because of pent-up consumer demand to replace aging vehicles and an appetite for aggressive deals in the showroom. Leveraging this opportunity, lenders have loosened loan standards fueling even more origination activity, in addition to lengthier loan terms that make it easier for consumers to afford payment cycles. However, lenders could face problems similar to past credit cycles because of the price softening taking place at the used-car level resulting in lowered retention values. As new sales volumes reach and exceed the 16- to 16.5-million level, retention values will deteriorate even more so to pre-recession levels.

How can lenders mitigate this risk to their portfolio by tracking a regular pattern of vehicle values? What's more, how can lenders better equip themselves to navigate the current growth patterns to identify vehicle segments that offer more risk, as well as identify segments that offer an opportunity for expansion?

Drivers Of Lender Growth

The auto-lending environment continues to broaden with large banks expanding their portfolios and new financial entrants seeking some of the profit potential. As reported in *The Wall Street Journal*, auto lending was the fastest-expanding segment of consumer debt during the second quarter of 2012, according to the Federal Reserve Bank of New York. Bank figures show U.S. consumers had \$750 billion in outstanding auto loans during this time frame, representing \$13 billion more compared with the first quarter of the year¹. Furthermore, the current level of 58 million total outstanding loans is at its highest level in thirty-seven months according to Equifax's National Consumer Credit Trends Report².

Auto lenders continue to weigh this growth potential against the future risk it could present. Growth in labor markets and historically low levels of auto loan delinquencies have combined to help lenders relax their standards, fueling an appetite for new-car purchases. And despite ongoing economic concerns surrounding inflation and the potential for an increased tax climate, the industry is operating full-speed ahead with expectations for continued new-car sales growth in 2013, albeit at maybe half the percentage growth of the previous three years.

More Focus On Collateral Risk

Focusing too much on consumer credit could pose a hidden danger to many lenders especially as lenders expand to lengthier loan terms. According to Experian Automotive data in a recent issue of *Automotive News*, auto loans that ranged from 73-84 months

accounted for 12.8 percent of total loans during the third quarter of 2012. This length of loan range represented just 10.3 percent of all loans during the third quarter of 2011³.

Lengthy loans represent a heightened level of risk because there is a greater possibility of consumer credit default, and significant vehicle value changes that could impact recovery rates and impact the overall value of a portfolio. While the movement of collateral values in a portfolio is closely monitored in a down economy, many lenders lose sight of its importance during a period of industry growth similar to the current climate.

Vehicle values and retention levels play a critical factor in the overall profitability of a lender's portfolio. Only focusing on consumer credit leaves a risk manager vulnerable to fluctuating depreciation and the potential for increased loss rates, all impacting the portfolio's bottom line, as well as the auto lender's ability to focus on opportunities for growth. Beyond that, regular monitoring of residual vehicle values are essential in forecasting anticipated changes to risk levels on certain segments and models within the same segment.

Loss Rates & Layered Risk

Black Book can improve loss rates for lenders by accurately identifying important vehicle and segment patterns. Prime auto finance loss rates have continued to decline and have reached historically low levels. Subprime loss rates have remained relatively stable despite the growth due to lower credit standards. More importantly, the loss rates have an inverse correlation with vehicle values. As values depreciate faster, loss rates rise. There can be more than a 100 percent swing in loss rates due to vehicle volatility. Near the end of 2008 and early 2009, losses were driven up, partly due to softness in vehicle values. As these values dropped, the recovery rates fell on the repossessed vehicles. Black Book can help lenders understand this through updated valuation data and historical trending.

Loss rates can be impacted by a number of risk factors including fluctuating loan-to-value ratios (LTV) as collateral values change, credit score movement and economic factors that affect a consumer's capacity to repay the loan. Currently, lenders focus primarily on the monitoring of credit scores. However, it is critical to focus on all the layers of risk that impact delinquency rates and loss severity. As an example, an entry-level car historically retains 46 percent of its new equipped retail price after three years. However, with its currently lower depreciation, the three-year retention value adjusts to 49 percent of its value, which is 3 percent higher than its traditionally recorded level. Understanding the impact on LTVs, combined with credit movement can improve delinquency rates by allowing lenders to better understand how a vehicle will perform in a given portfolio. Risk

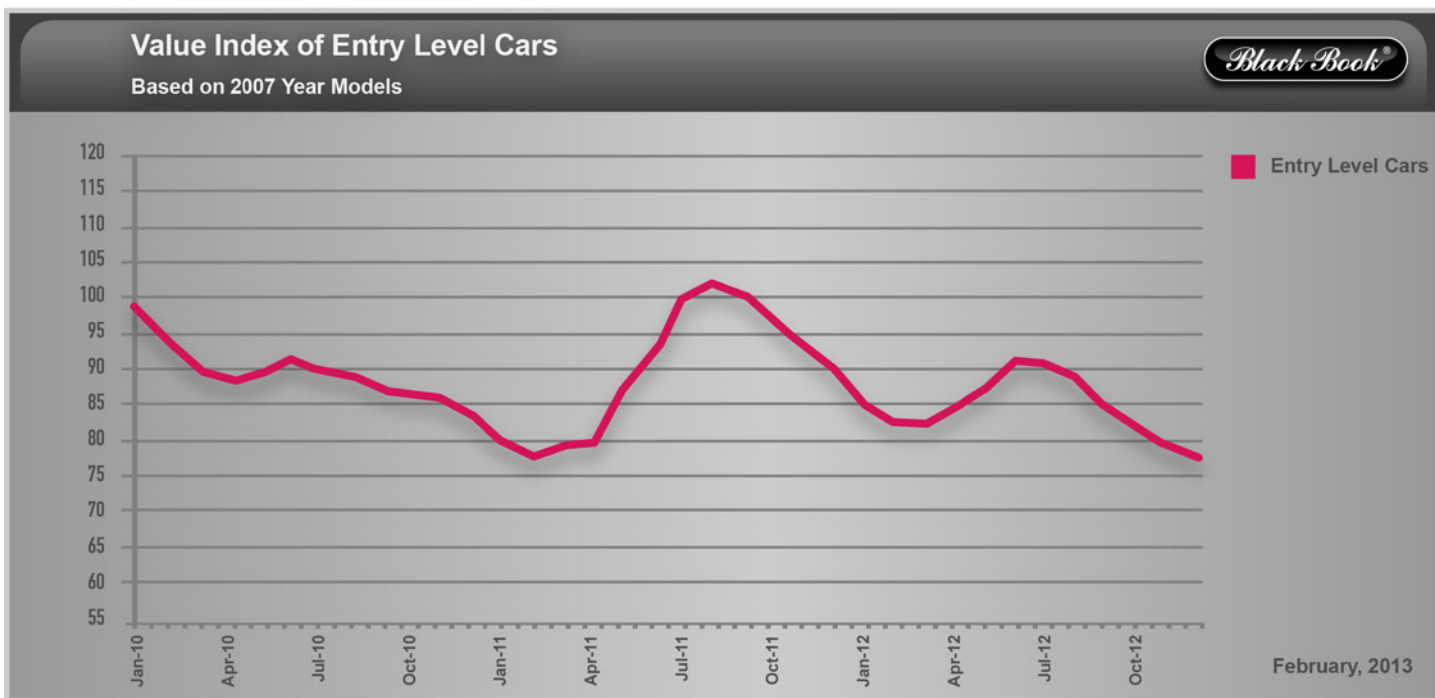
managers who regularly monitor these risk patterns based on Black Book data can make educated forecasts on specific vehicles and segments when analyzing their portfolio.

Entry-Level Cars Demonstrate Volatility

Taking a deeper dive into entry-level cars, the segment has demonstrated anything but a straight line in terms of retention values over the last few years. According to Black Book, segment values increased 22 percent in 2010 between December and June, and then showed significant declines the remainder of the year. In more recent history, the segment values showed an 18 percent decline during the second half of 2012, and the outlook could be looking at more turbulence given a variety of reasons.

Vehicles in the entry-level space are enjoying more of a marketing spotlight from manufacturers, increasing the overall interest among consumers. What's more, entry-level vehicles are pulling in customers who have typically been mid-size vehicle shoppers because the newly redesigned entry-level cars are larger in size and offer additional features. That being said, there are more players in the segment offering additional choices, and fuel prices are expected to remain relatively mild throughout 2013 which will create more demand for larger cars and trucks.

Entry-Level Segment Has Shown Extreme Volatility

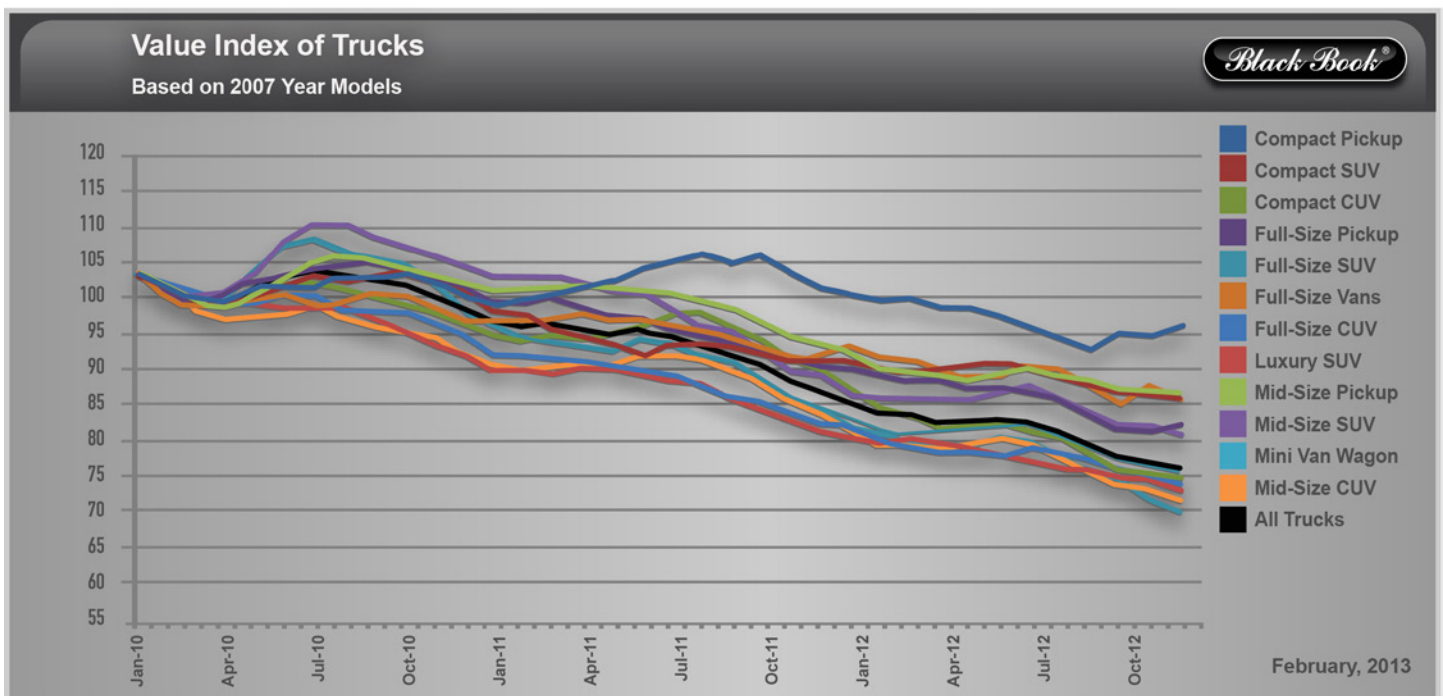


All of these factors impact the overall retention value of the entry-level segment, which is why Black Book monitors valuation data on a daily basis so they can provide lenders with accurate data that helps forecast anticipated vehicle depreciation.

Truck Segments Show More Stability

Trucks, as opposed to cars, have shown less volatility in recent history. Despite fluctuations in gas prices over the last three years, with pockets of drastic changes at times, truck segment values have declined a more stable -6 percent in 2010, and -9 percent in both 2011 and 2012 according to Black Book values. The outlook for trucks may turn more positive beginning in 2013 if construction spending continues to expand and economic growth maintains its current rising pace. Both new and used supplies are also better aligned today to meet real-world demand. Additionally, there are fewer players in key truck segments, such as Full-size pickup trucks, while crossover segments continue to capture a larger audience with model sizes that have grown in size to satisfy drivers looking for more vehicle versatility.

Truck Values Have Declined At A More Stable Pace

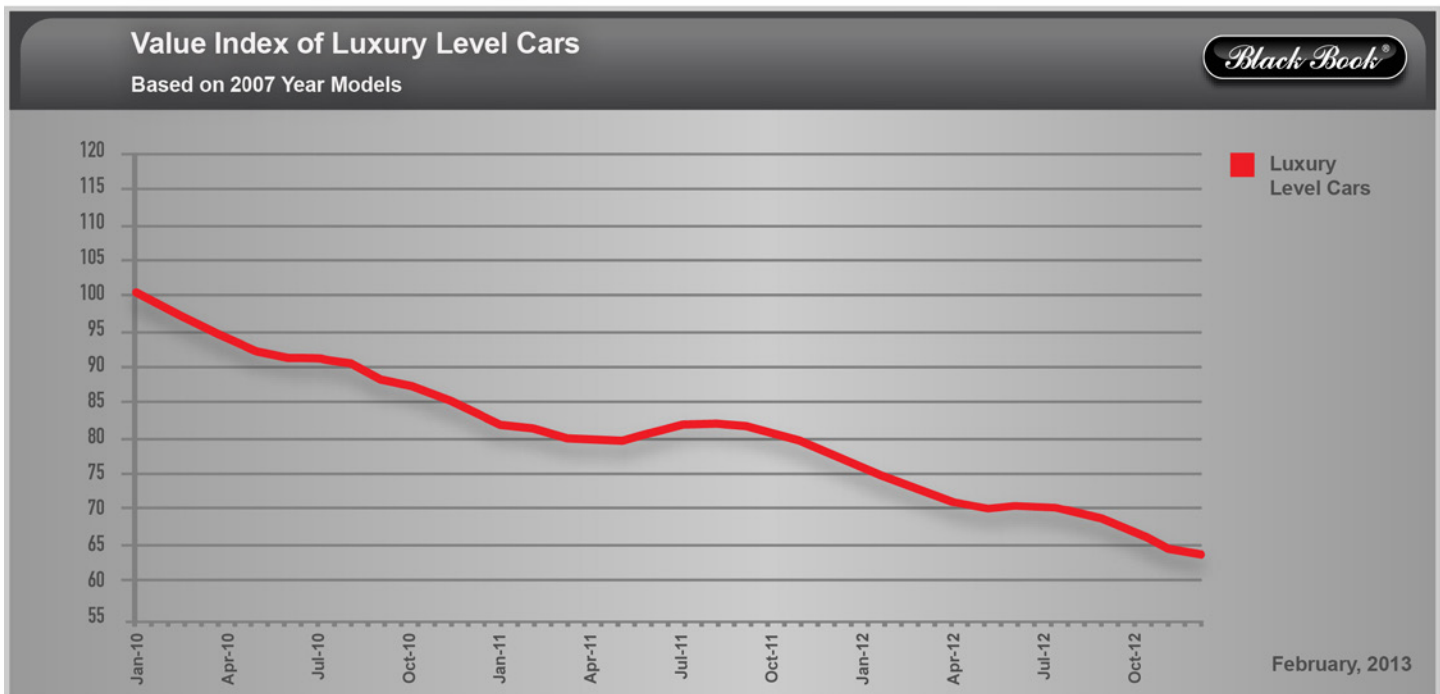


Opportunities To Take On More Risk

Regular tracking of vehicle values of specific segments through Black Book is an essential step in monitoring and measuring risk associated with fluctuating vehicle values. Updated vehicle values allow a lender to measure and monitor where there is increased risk in the portfolio. However, tracking historical patterns based on regularly updated current pricing valuations, and forecasting future residual values, allow lenders to uncover opportunities to take on additional risk.

Tracking historical depreciation for each vehicle and then tracking if the values are trending normal is a critical step. Black Book's regular feed of data and continual analytics help manage a database of vehicles that matter to a specific portfolio. This regular flow of data has become increasingly important to help lenders understand and manage their risk. Luxury-Level cars may provide a strong clue for opportunities to increase portfolios. The appetite for luxury cars grew throughout 2012, with Volkswagen-owned Porsche increasing global sales nearly 40 percent compared with 2011. In America alone, 2012 sales were up 71.4 percent compared with 2011⁴.

Steeper Decline In Luxury Level Values Signals Lower Loss Rate



This increased sales data is important as dealers and lenders look to expand sales programs and build portfolios. According to Black Book, Luxury-Level cars have seen a steeper decline in values from June through December of 2012 in comparison to the same periods in 2010 and 2011. This signals a lower loss rate for lenders down the road. As the economy improves and disposable income levels rise, luxury level cars may show relatively strong performance for portfolios.

Conclusion

The auto industry continues its path toward growth, driven largely by new and more readily available lines of credit. Existing lenders are relaxing their standards based on economic conditions indicating changing risk to consumer credit, and new lenders have entered the market to capture a growing share of customers, particularly in less-than-prime customer pools. Because of this environment, lenders need to focus on a more regular pattern of tracking vehicle values to measure risk from volatility. Modeling and reducing such risk is possible through access to data that is timely, unbiased and accurate. Black Book's suite of values includes wholesale, trade-in and retail values that are updated on a daily basis. Black Book also offers several tools to help with loss forecasting, which include historical trending, depreciation curves and Black Book's Risk Score to help measure the impending risk of downward or upward movement in specific vehicles and vehicle segments. These tools are all offered with detailed analytics provided in a variety of file, portal, web or mobile platforms.

Appendix

- 1 "Lenders Rev Their Engines", *The Wall Street Journal*, November 23, 2012
- 2 "Auto Loans Reach New Highs", *Used Car News*, December 27, 2012
- 3 "Ford Credit Bucks Shift To Longer, Riskier Loans", *Automotive News*, November 21, 2012
- 4 "What Fiscal Cliff? Luxury Car Sales Are Rising", *Car Biz Today*, December 19, 2012



LENDER SOLUTIONS

DATA DRIVING INNOVATIONSM

2620 Barrett Road
Gainesville, GA 30507
Phone (770) 532-4111
Toll Free (800) 554-1026
www.BlackBookUSA.com

Black Book is a registered trademark of Hearst Business Media Corporation.
© 2013 Hearst Business Media Corporation. All rights reserved.