ECONOMIC TRENDS COMMENTARY

Subprime Auto Loans: A Second Chance at Economic Opportunity

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Subprime auto loans seem to be an all too easy target these days. An increased negative media focus on some worst-case scenario situations has drawn criticism to an industry that—rather than a pointed finger—deserves some recognition for weathering the storm of the Great Recession, and ultimately helping to pave the way for our recent economic recovery.

A close examination of actual loan data from Equifax of more than 210 million consumers is very revealing. The numbers show that subprime auto lending has been delivering a viable second chance for many consumers who fell on hard times during the recession, and have since been struggling to rebuild their financial and credit risk standing. Our data also shows that subprime is a well managed and stable subset of automotive lending—a subset that has been a key driver of our overall economic health.

The future looks bright for the automotive industry. Add in recovering housing and construction markets, plus lower fuel prices and it is not surprising that the 2015 consensus forecast for new car and truck sales is three to seven percent growth. We believe that subprime auto loans have greatly contributed to this bounce back, and will continue to serve as an essential tool for helping those consumers with less than perfect credit history get into a vehicle that fits their needs.

Dire warnings that subprime auto lending is getting out of hand are generalizing the practices of predatory and poorly originated lending as the norm for all subprime lenders when, in reality, our data does not support those warnings. More than ever before, today's auto lenders are armed with new data sources and consumer insights that give them an unprecedented understanding of how to evaluate the creditworthiness of the deal based on the credit, collateral (down payment) and capacity to repay of the borrower.

Subprime Lending Growth—Strong But Not the Strongest

Unlike the wildfire growth of the housing market and subprime and non-traditional mortgages from 2004 through 2008, subprime auto lending has consistently grown at a controlled, steady pace. In fact, Equifax data shows that prime lending is growing at more than double the rate of subprime lending. Specifically, the number of auto loan originations for consumers with nonprime credit scores (defined as consumers with an Equifax Risk Score^{SM} less than 620) increased 2.4% from 2013 to 2014, while the number of originations for consumers with prime and super-prime credit scores (defined as consumers with an Equifax Risk Score of 620 and above) increased by 5.1% during the same period.[1] This trend applies to the full spectrum of credit scores, as demonstrated in Figure 1 below (red bars are the credit score ranges commonly considered to be subprime and deep subprime).

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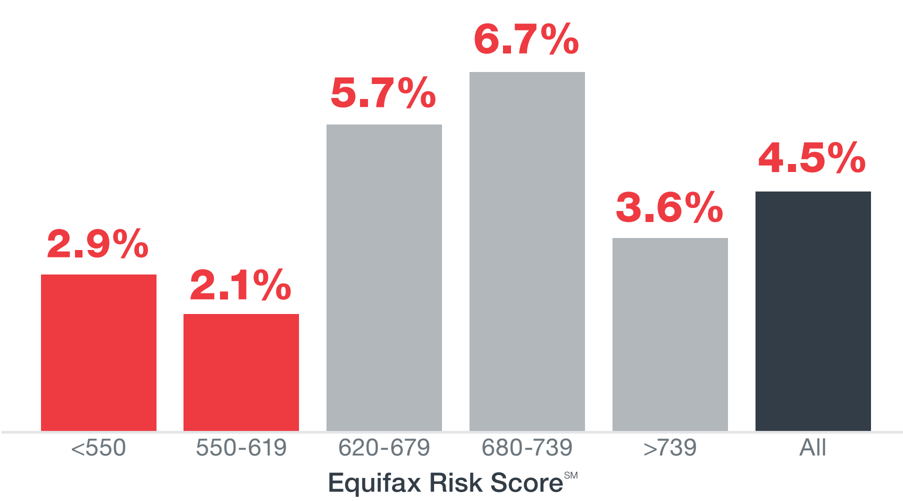
1 This definition of a subprime loan is one dimensional and simplistic. In reality, what defines a subprime loan from a prime or near prime loan is a collection of factors not observable in our data, but which might include characteristics of the loan terms, the borrower's financial condition, and the down payment amount or source.

FIGURE 1

Percent Increase in Auto Originations in 2014 Relative to 2013 by Credit Score Range



Source: Equifax Inc. Data as of January 2015. Data reflect tradelines opened and reported through December of the origination year.

Subprime Loan Performance

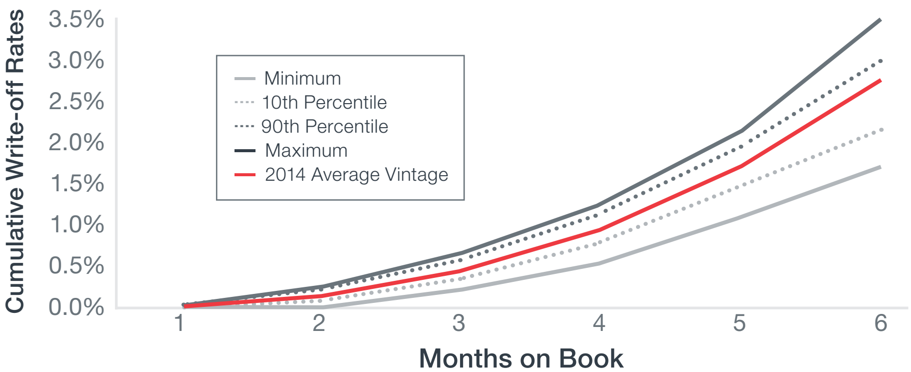
More importantly, these subprime auto loans are performing well within the expected range. Figure 2 displays the cumulative write-off rate (as a percentage of total balances) during the first six months after origination for borrowers with credit scores below 550, the deep subprime range, by vintage. We use this metric as it gives us an early indicator of performance that can easily be compared across vintages. It also allows us to examine, at least partially, those loans originated in 2014. The solid lines at the top and bottom are the maximum and minimum write-off rates we saw for the 2006-2013 monthly vintages; the dashed lines are the 90th and 10th percentile rates respectively; and the red line represents the average of the first six vintages from 2014. Importantly, the 2014 vintage falls squarely in the middle performance wise. The best performing recent vintages hail from 2009, while the worst are from 2007.

This appears to be a reflection of a gradual but controlled loosening of credit in the auto space. Lending standards are not as restrictive as they were during and immediately after the recession—a painful period of time for consumers, lenders and the auto industry. This slight increase in write-offs is both accepted and anticipated as a greater volume of quality subprime loans are originated.

FIGURE 2

2014 Cumulative Write-off Rate for Deep Subprime Auto Loan Sector

Percent of Balances



Source: Equifax Inc. Data as of December 2014. Deep subprime defined as loans to borrowers with origination Equifax Risk Score[SM] of less than 550. Months on Book=1 refers to the month following origination. Rate includes Bankruptcy. Loans originated in January through June 2014 are included for 2014 vintages. Minimum, maximum, and percentiles are calculated based on all monthly vintages from 2006 through 2013.

Without Quality Subprime Options, Consumers Lose

In the wake of the Great Recession, many consumers lost their jobs and homes, which ultimately led to a drop in their credit scores. Some have since recovered and have worked hard to rebuild their credit, but many continue to battle the stigma of a bad credit history. Others have still not had an opportunity to prove that their loan repayment patterns have changed.

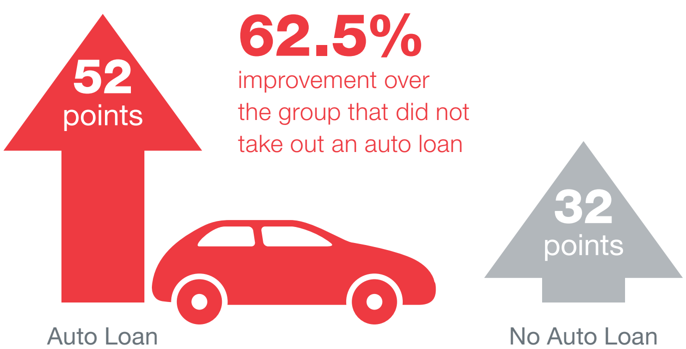
While there has been a great deal of conversation around the drawbacks and risks of subprime auto lending, there has been less discussion of the benefits to the individuals who are borrowing the money and the economy as a whole. This section takes a look at research done by Equifax that examines the three-year migration of the deep subprime credit scores for those consumers who originated an auto loan in comparison to those who did not.

A Path to Redemption

We began by considering the population of deep subprime credit consumers with an Equifax Risk Score below 550 who originated an auto loan in June of 2010 as our treatment group, and a random sample of consumers with a credit score below 550 in June of 2010 who had no auto loan originations within six months of June 2010 as our control group. We then examined the change in their credit scores exactly three years later, in June of 2013. The results, shown in Figures 3 and 4, show that, in aggregate, consumers with deep subprime credit scores who originated an auto loan had a larger increase in their credit score compared to those who did not.

FIGURE 3

Median 3-Year Increase in Credit Score for Deep Subprime Credit Consumers

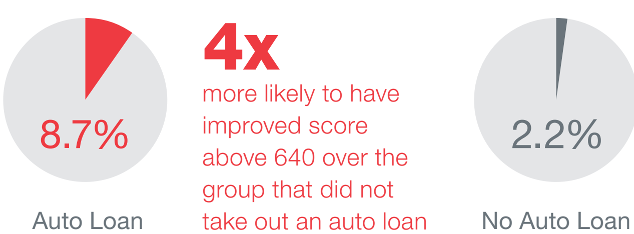


Source: Equifax Inc. Data as of December 2014. The Auto Loan cohort consists of all consumers with an Equifax Risk Score℠ (ERS) of less than 550 in June 2010 who originated an auto loan in that month. The No Auto Loan cohort consists of a sample of consumers with an ERS of less than 550 in June 2010 who did not originate an auto loan between January and December of 2010.

The credit scores of consumers who received a subprime auto loan increased over the three-year period with a median improvement of 52 points. This is a 62.5% improvement over the group that did not take out an auto loan, who only improved by 32 points. Even more telling, those that took out an auto loan were four times more likely to have improved their score above 640 compared to the consumers who did not take out a loan. This distinction is critical as it affords them much greater access to credit and therefore an improved economic situation. In addition, more than 25% of those who took out an auto loan in June 2010 improved their credit score by 100 points or more by June 2013.

FIGURE 4

Percent of Consumers With an Equifax Risk Score℠ Moving From Below 550 to Above 640



Source: Equifax Inc. Data as of December 2014. The Auto Loan cohort consists of all consumers with an Equifax Risk Score (ERS) of less than 550 in June 2010 who originated an auto loan in that month. The No Auto Loan cohort consists of a sample of consumers with an ERS of less than 550 in June 2010 who did not originate an auto loan between January and December of 2010.

New Tools, Better Outcomes

In addition, innovation is drastically changing the landscape of auto financing. Today's automotive retailers and lenders have a new generation of highly sophisticated and effective tools available that help identify well qualified buyers through rich data and insightful analytics. The days when credit scores alone drove lending decisions are almost gone. From real time individual income and employment verification, to overlays of behavioral data and regional economic cycles, underwriters have more information than ever to draw upon. These and other advances in technology can help lenders lower risk, reduce fraud, remove stipulations and, in some cases, even provide a lower cost loan for borrowers in the subprime category.

For example, leveraging instant income and employment verification provides numerous benefits to lenders and borrowers. Chiefly, verification helps reduce fraud and misrepresentation by providing direct-from-employer information that lenders can use to determine the borrower's ability to repay. In one study conducted by Equifax, borrowers who overstated their income on an auto financing application by more than 15% had a serious delinquency rate (60 or more days past due) more than triple the rate of borrowers who did not inflate their income. Borrowers benefit as well: they are relieved of the burden of providing documentation and are able to complete the transaction faster. Ultimately, by providing more verified information into underwriting, lenders can confidently consider extending loans to those with less than perfect credit.

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Mortgage Lending is to Auto Lending as Apples Are to Oranges

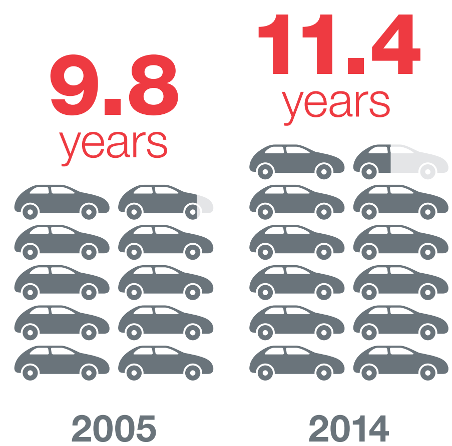
One commonality we've seen has been the comparison of the subprime auto lending market to the subprime mortgage lending practices that preceded the 2008 recession. While such an analogy seems true on the surface and certainly makes for sensational headlines, there is little evidence to support the premise.

To begin, there are vast differences between the automotive and housing industries. A car is a depreciating asset that is often essential for everyday family mobility and employment. Very few borrowers—other than perhaps vintage car collectors—originate an auto loan expecting to resell the vehicle two years later for profit, and, as such, there is little incentive to take on an unaffordable loan. Yet this was exactly the behavior many consumers had exhibited prior to the burst of the housing bubble. Many consumers believed that a home was an asset that's value could only move in one direction—up. In turn, people borrowed more than they could comfortably afford, with loans terms that were ill-suited to their long-term financial health. They assumed they could refinance the loan or sell the home for a nice profit if and when the payments became burdensome.

Unfortunately, when values stopped rising, the bubble burst.

When a consumer can no longer service all of their debt obligations they have to make choices among which ones to pay. While both are collateralized debt markets, another differentiator between mortgage and auto lending markets is what happens when a borrower stops making payments. In mortgage lending, the lender forecloses on the home through either a statutory or judicial process, depending on state law. Prior to the Great Recession, the average number of days between the due date of the last paid installment and the termination of the borrower's ownership at the foreclosure sale was 355 days.[2] Since the housing bust, foreclosure timelines have stretched to more than 1000 days in some states with judicial foreclosure processes during which time the borrower could occupy the home for free.[3]

In auto lending, by contrast, the lender may determine that the debt is uncollectable and repossess the vehicle in as little as 60 days following nonpayment. The immediacy of the consequences of default plays a role in the payment prioritization process. Further, a foreclosure has the additional impact of depressing home values throughout the neighborhood which may then have a cascading effect. The repossession of a vehicle has no effect on the value of a neighbor's car.



Average Age of a Registered Vehicle[4]

While cars are a depreciating asset, consumers are nonetheless maintaining their personal vehicles longer than ever. The average age of a registered vehicle in 2005 was 9.8 years. In 2014, that number rose to 11.4 years.[4] Longer manufacturer warranties, increasing quality and, of course, a shift in consumer discretionary spending have all contributed to the fact that cars and trucks are staying on the road for longer periods of time. That translates to stronger, more accurate and predictable collateral for auto loans, a direct contrast from the often speculative value of houses during the run-up to the financial crisis.

2 Amy Crews Cutts and William C. Merrill, "Interventions in Mortgage Default: Policies and Practices to Prevent Home Loss and Lower Costs" in Borrowing to Live: Consumer and Mortgage Credit Revisited, Nicolas P. Retsinas and Eric S. Belsky, eds. 2008, Washington, DC: Brookings Institution Press. See Table 6.

3 RealtyTrac, "U.S. Foreclosure Market Report™ for March and the first quarter of 2014," http://www.realtytrac.com/content/foreclosure-market-report/march-and-q1-2014-us-foreclosure-market-report-8034, accessed 2/11/2015.

4 Source: IHS Automotive. http://press.ihs.com/press-release/automotive/average-age-vehicles-road-remains-steady-114-years-according-ihs-automotive

The Subprime Auto Bubble is Fiction, Not Fact

The basis for a bubble starts with accelerated expectations in asset values that are then fed by loose lending standards. Eventually, this dangerous mixture leads to a high rate of consumers defaulting on loans they cannot afford.

This was the state of the housing market in the run-up to the Great Recession. Homes purchased with the belief that prices would continue to rise quickly was the norm, as were non-traditional mortgages that were structured on hope, not pragmatism. Unrealistic loans became commonplace, and they were designed with features to maintain the illusion of affordability such as: negative amortization, interest-only, adjustable rates, low or no income and employment documentation, and no money down. In addition, home construction exceeded population growth. In 2007, when home values peaked, the tidal wave reached its apex and crashed into America, ultimately leaving devastation in its wake as millions of homeowners defaulted on their loans and lost their homes to foreclosure. The sheer scale of the foreclosures and losses on mortgage assets pushed banks into failure and led to the meltdown.

The Future of Subprime Auto Lending is Sound

More than 25% of those who took out an auto loan in June 2010 improved their credit score by 100 points or more by June 2013.

With only a few short years separating today from the depths of the Great Recession, it is natural and prudent to be skeptical of the recent increase in subprime auto lending. Nevertheless, it is imperative that this curiosity be answered with data and not anecdotes, particularly given the benefit our analysis shows that subprime auto lending brings to those consumers who exited the recession with blemishes on their credit. And when the data available today is examined, it becomes clear that there is no definitive evidence that suggests an auto subprime loan bubble similar to the housing bubble is forming. This does not mean that we have eliminated all risk from consumer auto lending, but the new tools and technology available today, along with heightened awareness of what contributed to the housing bubble formation, enable lenders to better manage risk, and contribute to a very different subprime auto lending market today.

Without question, vigilance is the watchword. We must closely monitor the lending environment for indications of changing conditions. However, without access to quality and reputable subprime lending, borrowers will seek alternative, less dependable sources of credit—which could ultimately hurt them. In a world where there is a great deal of consternation regarding the stagnation of the middle class, subprime auto lending can provide help to consumers with less than perfect credit so they can improve their financial standing—and their future.

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