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What Drives U.S. Auto Loan Delinquencies?

BY CRISTIAN DERITIS — FEBRUARY 27, 2019
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What Drives U.S. Auto Loan Delinquencies?

By Cristian deRitis

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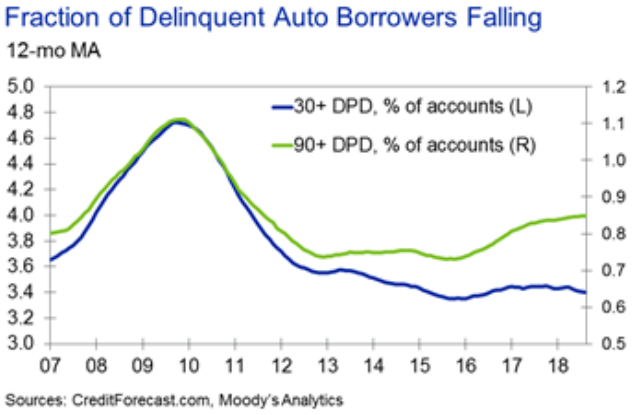
- A recent report raised concerns about the number of past-due auto loans.
- However, combined with improvements in the job market, the performance of auto loan and lease portfolios has stabilized over the past two years.
- While the trends look favorable, overall solid performance should not be interpreted to mean that all borrowers are doing well.

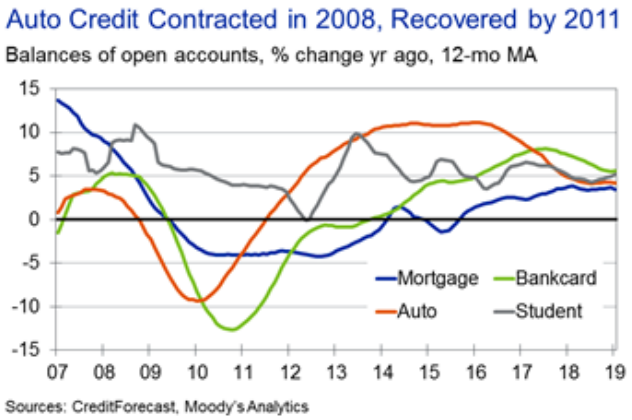
The New York Fed recently raised an alarm about auto credit suggesting that more than 7 million Americans are at least 90 days past due on their auto loans. While there are pockets of concern around long-term loans to borrowers with weak finances, the Fed's conclusion was based on a measure of loan performance that includes loans that had been written off previously—even years ago. If instead we focus on the performance of loans that are on lenders' books today, we find that auto credit overall is performing favorably, with the fraction of borrowers who are 30 or more days past due near its lowest level in the history of the data back to 2007.



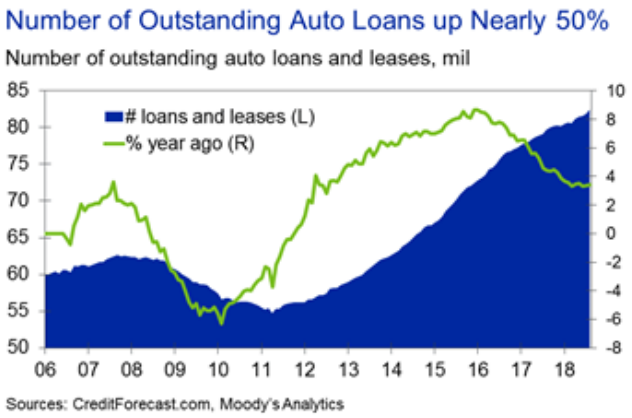
Although 90+ day delinquency and default rates have risen from their post-recession lows, this is more a reflection of credit normalization than an overheating market. The performance of auto loans and leases is clearly worth watching, but it's premature to call it a crisis.

First in, first out

Auto loan and lease originations fell dramatically during the Great Recession as new-vehicle sales collapsed. It was the first consumer credit product line to experience a year-on-year contraction in 2008—anticipating both mortgage and credit card balances. Auto credit was also the first product to recover after the recession (student loans never experienced a decline). Fueled by low interest rates and pent up demand for new cars, trucks and SUVs, auto credit expanded at over a 10% annual rate from 2013 to 2016.

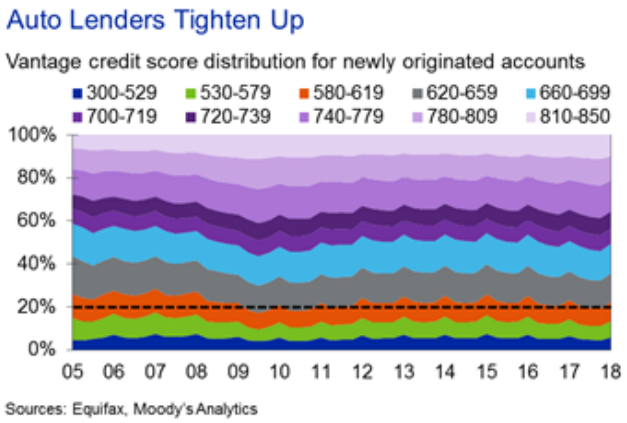


Lending standards loosened progressively throughout this expansion as lenders sought to keep the pace of growth elevated by offering loans to borrowers with lower credit scores. Loan terms lengthened as lenders looked to keep monthly payments at manageable levels in spite of the desire of borrowers to purchase more expensive SUVs. As a result of the expansion, the number of outstanding auto loans today is 30% higher than in 2007 and 50% higher than the bottom in 2011.

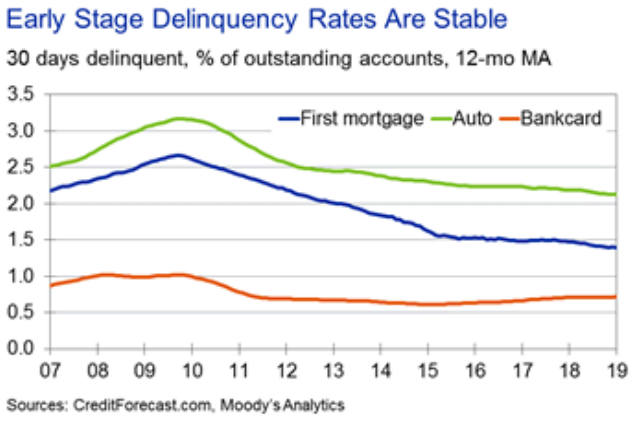


The loosening trend caught the attention of industry analysts, including Moody's Analytics. Industry observers were particularly worried about the layering on of risks that was reminiscent of behavior during the housing bubble. Lenders can manage the increased default risk of a borrower with low credit by requiring a larger down payment or lower debt-to-income ratio. But when these requirements are waived, the combination of risk factors can make loans particularly vulnerable to any type of income shock.

These warnings combined with rising default rates in 2016 led lenders to pull back on the expansion. Banks and credit unions grew more cautious along with bank regulators. Captive auto lenders, which tend to be more willing to make loans to support the sales of manufacturers, also tapped the brakes given pressure from investors. As many auto loans and leases end up getting packaged and sold off in asset-backed securities, originators are sensitive to the credit quality and yield requirements of Wall Street investors. Subprime auto lending (to borrowers with credit scores below 620) didn't disappear but leveled off at a 20% share of the market.



Combined with improvements in the job market, the performance of auto loan and lease portfolios has stabilized over the past two years and is projected to remain constant if not improve as the job market remains strong. This trend is at odds with the New York Fed's suggestion that the share of delinquent borrowers has risen dramatically. The difference has to do with how historical defaults are measured.



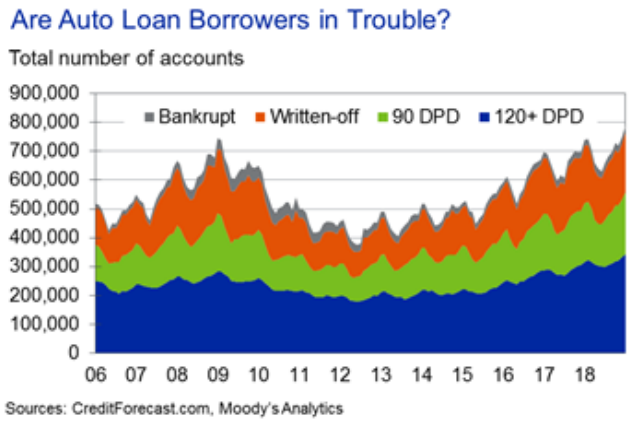
When calculating the number of delinquent borrowers in a given period, the Fed included those consumers with an auto loan or lease charge -off in their credit history along with those who are currently delinquent. The logic for doing so is that consumers who defaulted in the past may still be on the hook for outstanding balances—even if their lender has already written off any losses. This is true even if the vehicle has been repossessed in states with deficiency judgment statutes.

Though technically accurate, there are a few problems with this measure when it comes to assessing current credit conditions. First, while lenders may have the right to pursue deficiency judgments, they may choose not to, since the legal costs required to file a claim can exceed the amount the lender may hope to recover. In some states, including California, lenders are not permitted to pursue deficiency judgments after they repossess vehicles, so these charge-offs do not represent an ongoing obligation for defaulting borrowers. The same is true for accounts discharged through a bankruptcy. Second, written-off accounts continue to be reported on consumer credit reports for seven years. Including these observations in a measure of delinquency may be more of a reflection of previous performance than current conditions.

Understanding how many consumers have default events in their credit histories is important, because a history of default can impact the ability of borrowers to access credit and their future credit performance. But that's a different question from understanding how outstanding auto loans and leases are performing today.

Restricting our measurement to the performance of active, outstanding loans allows us to determine if lending standards are appropriate or if actions are needed today to head off rising losses in the future. Based on this definition, 750,000 borrowers were either more than 90 days delinquent or experienced a default as of the end of 2018. While on par with the level experienced during the Great Recession, it is less

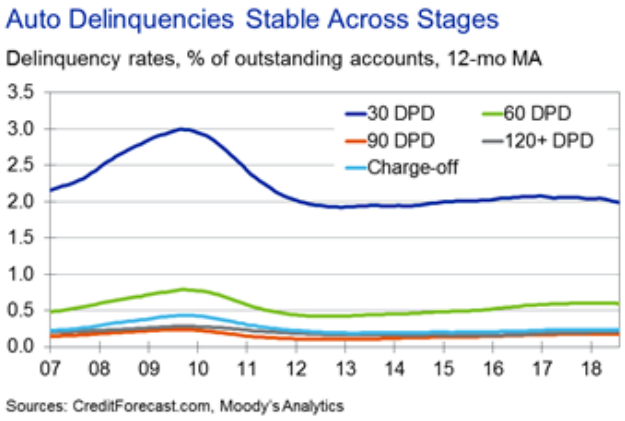
concerning given the increased size of the market.



The revised calculation does not diminish the need to be vigilant when it comes to auto credit. The rapid growth of the industry demands attention. But including historical charge-offs in the definition pollutes the measure and may send misleading signals. The risk from sounding an alarm on auto lending is that it diverts attention from credit products that are at higher risk such as private-label credit cards and unsecured personal loans.

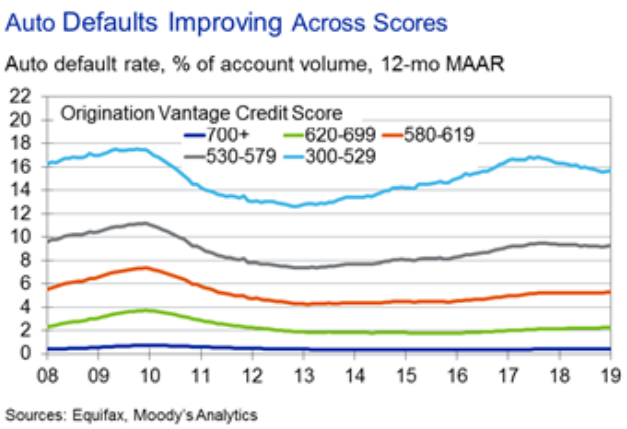
Lenders report improvement

Another problem with including prior defaults in performance calculations is that it does not conform to standard industry practices. Auto finance companies and financial institutions with auto credit portfolios report losses on their active loan portfolios in their financial statements. For example, GM Financial's 2018 10-K indicated that 4.8% of its portfolio was either more than 30 days delinquent or in repossession. This is an improvement over the previous year and inconsistent with the Fed's report that approximately 4.8% of all auto loans are 90+ days delinquent. GM Financial's figures are more consistent with the performance rates reported by Equifax and with the conclusion that delinquencies remain well below Great Recession levels.



Pockets of risk exist

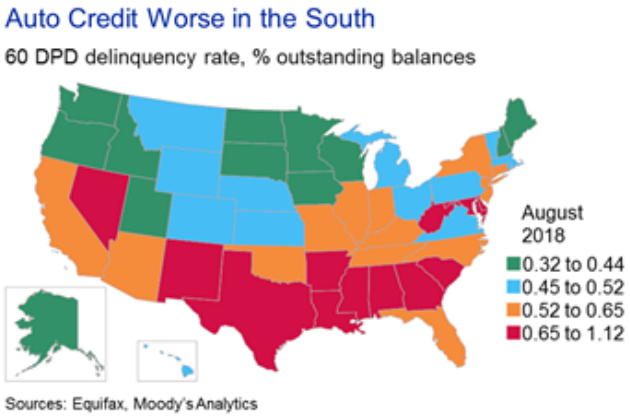
While the trends look favorable, overall solid performance should not be interpreted to mean that all borrowers are doing well. There are riskier borrower segments that require immediate attention. Breaking out performance by credit score shows that borrowers with extremely low scores have not been performing nearly as well as their prime counterparts. This is a direct reflection of the cyclicality of credit scores and the fact that additional risk layering makes some borrowers particularly vulnerable to financial shocks.



As the economy has improved over the past decade, the average credit score in the population has risen. More people have been able to pay their bills on time, causing scores to rise. While this is favorable, it also suggests that borrowers who buck the trend pose particularly high risk. A consumer in 2009 may have had a low score due to the Great Recession. Consumers with low scores in 2019, when unemployment is near its 50-year low, likely have financial issues that make them inherently riskier.

Default and delinquency rates for this high-risk group have stabilized in the past year, suggesting that auto lenders are taking these risks seriously as they adjust their lending policies. Nonetheless, complacency remains a risk factor should competition for borrowers heat up and originators feel pressured to relax their standards.

Performance differences vary geographically as well. Lenders need to be vigilant of potential risks to local economies when managing their portfolios. Based on Moody's Analytics research, 15 U.S. metropolitan areas out of 403 are currently classified as being at risk of recession. Local banks and credit unions may be particularly vulnerable to the concentrated risks within a region.



Loan amortization terms remain long by historical standards but have stabilized. A longer term does imply that a borrower will have negative equity in the vehicle for a longer period of time, but that alone doesn't necessarily translate into significantly higher risk. Extending loan terms when rates are at or close to 0% may be perfectly rational and financially savvy for borrowers who have the means to pay.

A longer loan term becomes a risk factor when borrowers rely on term extension to get their monthly payments down to a minimum viable level. As a result, loans with terms longer than 72 months may have weaker performance than shorter loans to borrowers with similar characteristics. While longer loan terms are still prevalent, there are signs in the data that the trend of longer loan terms may be reversing. According to Moody's Investors Service, the average loan term for new vehicles originated in the third quarter of 2018 fell slightly to 68.5 months.

Vigilance, not panic

Auto manufacturing and financing remain important sectors of the U.S. economy. Consumers still value the mobility that their vehicles offer. The growth of auto credit is expected to decelerate in 2019 and 2020 as the economy slows and as consumers have saturated their excess demand for new vehicles. Policy uncertainty is causing both borrowers and lenders to take a more cautious view when it comes to either taking on or extending new credit. Rising interest rates and a slowdown in job market growth will further support a pullback in new loan originations.

Tailwinds from low unemployment and rising wages will support auto credit performance in the near term. Caution is warranted to ensure that performance doesn't deteriorate further and lending standards remain prudent. But it's too early to label auto lending as a crisis—especially once performance measures are put into context. The weakening in auto credit quality is relatively modest and expected and does not indicate there is a broader problem with household balance sheets or the economy.

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