The Ghost of Subprime Past?

It’s hard to believe, but it has been 10 years since the credit crisis claimed its first victim. New Century Financial, a subprime mortgage company filed for Chapter 11 bankruptcy on April 2, 2007. Economic Historians now mark the beginning of the historic collapse of the housing market and the financial crisis with the failure of this little known mortgage broker. Today, attention is being drawn to auto loans as the latest sector that might ignite the next credit crisis. We disagree.

In 2007 it was hard to imagine that the failure of this tiny subprime lender was going to be wrapped up in the history books someday with the likes of Lehman Brothers, but that is how history works. Now, car loans have become red hot and the possibility of widespread defaults is now drawing increased attention from the financial press and analysts.

Subprime (that dirty compound word) has migrated to this not-so-new area of consumer finance, as auto loans have become a huge growth driver for consumer finance companies, expanding at around 10% annually over the past five years. This growth rate has even outpaced student loan growth, which is often mentioned as the financial instrument likely to blow up next. However, student loans will soon be surpassed by auto loans, which are currently pushing $1.2 Trillion in total and still growing rapidly. The auto loan market, while large in absolute terms is still dwarfed by the approximately $9 Trillion mortgage market. Should delinquencies continue to rise on auto loans, it will have a much smaller impact on the total U.S. economy and banking system. Recently the media has begun to focus increased attention to some of the practices of auto lenders as more newly originated auto loans are falling within the subprime (FICO score below 660) categorization. You can see the tick up in such originations below.

Out of a Great Crisis Comes Great Data

Auto Loan Originations by Credit Score*

* Credit Score is Equifax Riskscore 3.0
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The New York Federal Reserve has put together an impressive collection of household debt data and statistics. These data are available free of charge and offer granularity on balances outstanding, delinquencies, and credit quality on all manner of consumer loans. As evidenced by the above chart, subprime auto lending wasn’t created this economic cycle, and the increase in subprime lending is a natural progression of the credit cycle. Furthermore, the percent of overall subprime originations as a percent of all originations was 34% in 2016, below the average of 37% for all subprime auto loan originations since 2004.

Given that it appears to be business as usual for auto lenders, why are so many pundits and analysts so concerned? Subprime lending has all but disappeared from the housing market, so the lending behavior in auto loans looks relatively reckless. This is a false equivalency. Auto loans are quite different from housing loans. Almost all housing loans are non-recourse in nature. This means the lender cannot pursue assets beyond the collateral secured by the loan (real estate). It may take many months or even a few years for a lender to take possession of a home in default and the condition of the home can decline dramatically while it is not maintained by the former owner who can continue to live there without paying the mortgage or rent. In contrast, auto loans are generally recourse loans, which means that the borrower is on the hook for any difference between loan value and vehicle value that could create negative equity. Automobiles are frequently and relatively easily repossessed and resold at auction, and in many cases lenders can still make money on a defaulted auto loan if they charge high enough rates for the risk. Consider a $20k 5-year loan underwritten on a car worth $24k at the time of purchase where the borrower has made a $4k down payment. If the lender charges 15% (not uncommon for the least creditworthy borrowers) the borrower will have to pay $570 per month in interest and principal on the loan. If the borrower defaults after one year, the lender only has to sell the car for $15k (net of costs to repossess) to break even on this loan (assuming a 10% weighted average cost of capital for the lender). This means the dealer can pencil in 1 year depreciation on the vehicle of 38% and still not lose money on the loan. Subprime auto lenders have quite a sizable safety cushion built into their lending activity, if they underwrite the risk correctly.

Despite some apparent pockets of excess in auto finance, there isn’t potential for a widespread economic collapse due to these lending practices. Putting subprime auto loans on par with subprime housing loans from a decade ago is not an accurate comparison. Given the differences in the assets being financed and the structure of the loans, the potential for a widespread economic catastrophe originating from car loans is unlikely. While we don’t think the risk associated with subprime auto lending puts the economy in jeopardy, we are considering potential ramifications for various market participants and continue to monitor the data closely.