OBSERVATION
TD Economics

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AUTO FINANCE A BRIGHT SPOT FOR U.S. LENDERS

Highlights

- Growth in auto loans has been driving the improvement in personal loan growth in the U.S., as consumer appetite for autos has been on the rise and lenders have been satisfying those needs with low-cost credit options.
- While credit markets have been thawing across the board, lenders have eased credit conditions considerably for auto loans, with a growing trend towards increased access for subprime borrowers.
- Longer loan terms, looser credit conditions and lower interest rates are improving overall auto affordability for consumers.

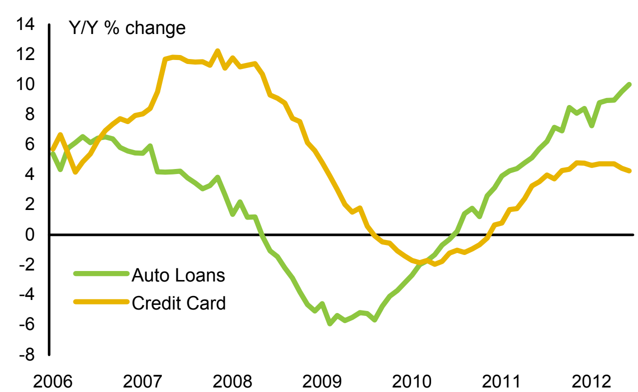
The auto sector has been one of the few bright spots in the struggling U.S. economy, with new vehicle sales rising faster than most had expected in 2012, jumping 13% to a 5-year high of 14.4 million units. This uptrend reflects a number of factors. A great deal of pent-up demand, aging cars on the road, several new/redesigned models hitting the market, and replacement demand following Hurricane Sandy, have all helped to buoy sales over the past year. Above all, an increasing household appetite to finance auto purchases and a growing desire of lenders to satisfy those needs through attractive low-cost choices have been playing a key role in the revival. In this report, we take a closer look at recent developments in automotive credit.

Demand for credit on the rebound

Given that most buyers (over 80%) require a loan in order to purchase a vehicle, access to credit is critical. During the financial crisis, lenders tightened standards, making it much more difficult for borrowers to obtain a loan. At the same time, however, demand for credit also sank, as households engaged in a massive deleveraging cycle. As a result, household balance sheets are in much better shape now than they were just a few years ago. The household debt-to-income ratio has fallen from its peak of 164% in the fourth quarter of 2007 to 139% in the third quarter of 2012 – the lowest level seen since 2004. With much of the deleveraging cycle now in the rear view mirror, American consumers, while still cautious, are starting to feel more comfortable with their financial positions and are ready to increase borrowing.

Auto finance is one area that is benefiting from the improvement in household financial positions. Since mid-2010, credit growth has been improving, with auto loans leading the way. After sliding 14% since mid-2007, growth in auto credit turned positive by 2011, with year-over-year growth accelerating to just over 5% by the third quarter of 2012. This was a 5-year high for

CHART 1
CONSUMER CREDIT NET OF CHARGE-OFFS



Sources: Equifax, Moody's Analytics, TD Economics

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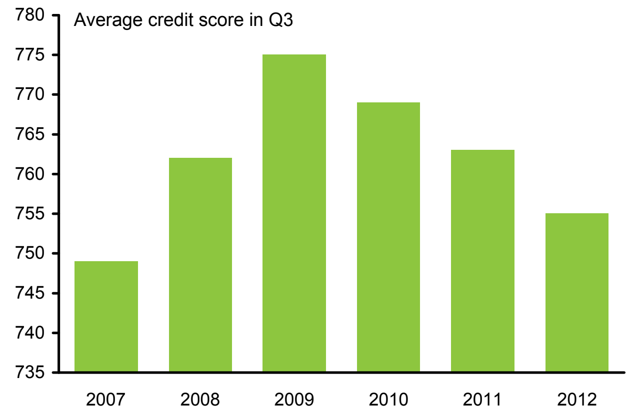
auto loan originations and a 4-year high for total auto debt balances. In comparison, credit card debt growth is still in the red (albeit improving from -10% to -3%) due to a large amount of charge-offs. Stripping away these writedowns, credit card growth is in positive territory, although still trailing the growth seen in auto loans. (See Chart 1).

Lenders responding

Lenders, recognizing significant opportunities and low delinquency rates, are responding. Supported by easy monetary policy conditions, lenders have been able to provide attractive borrowing rates – the commercial bank rate for a new car 48-month term has been declining steadily since 2007 and was sitting at 4.82% in the fourth quarter, marking the lowest levels seen on record going back to the early 1970s. (See Chart 2)

Moreover, while credit markets are thawing across the board, lenders have eased credit conditions considerably for auto loans. In fact, the average credit score for new car loans has been declining steadily since peaking in 2009. (See Chart 3) What's more, there has been a growing trend towards increased access to auto loans for subprime borrowers. By the third quarter of 2012, 42% of auto loans were subprime – up considerably from the low of 34% seen in 2009 and only a fraction below 2007 levels.[2] Relative to year-ago levels, the portion of auto loan originations that fell into the subprime category was up 14% for new cars and 6% for used cars, suggesting that lenders are increasingly becoming more comfortable taking on consumers with a tainted credit history. As a result, more consumers are able to purchase a vehicle, driving overall credit growth higher.

CHART 3
CREDIT SCORES FOR NEW VEHICLE LOANS

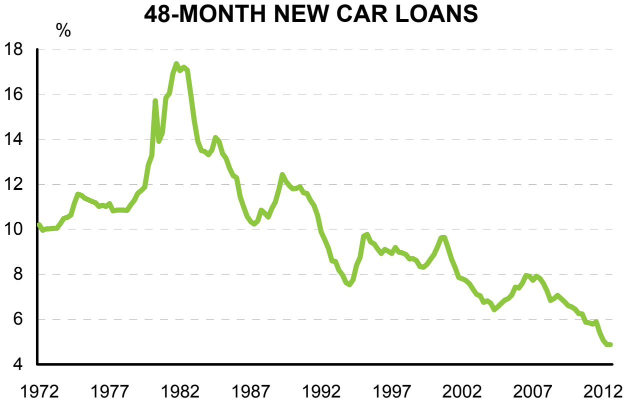


Source: Experian Automotive

While lenders should still exercise caution in giving loans out to higher-risk consumers, it makes sense that they would be more willing to increase risk exposure in the auto market. Delinquency rates on auto loans are the lowest among any loan type, and have been falling even with the increase in loans to subprime borrowers in recent months. (See Chart 4). Moreover, investor demand for auto debt is on the rise, with auto-loan securities up nearly 60% from year-ago levels, making autos the biggest class in the asset-backed securities market.[1] In turn, this allows lenders to extend even more financing.

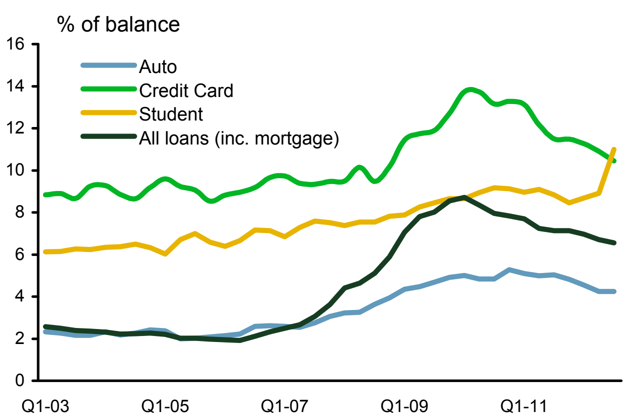
We should note that borrowers are classified as subprime based on their credit scores, and given the severity and the nature of the recession – driven largely by the housing market crash – coupled with the slow recovery, a larger

CHART 2
COMMERCIAL BANK INTEREST RATES: 48-MONTH NEW CAR LOANS

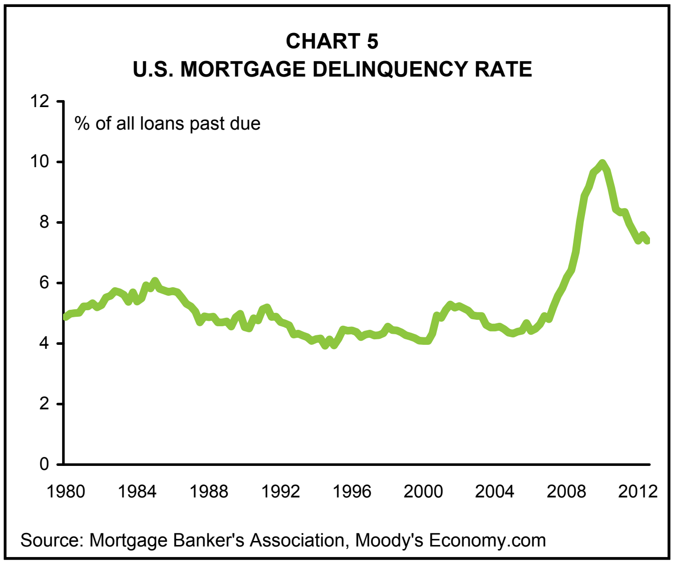


Source: Federal Reserve Board

CHART 4: LOANS 90+ DAYS DELINQUENT



Source: Federal Reserve Bank of New York;
Last quarter plotted: Q3 2012.



than average number of consumers are coming out of the recession with a blemished credit history. In fact, as shown in Chart 5, the delinquency rates of mortgage holders shot up much higher during the financial crisis than during any other time in history. Moreover, the increase in subprime lending in the auto space does not necessarily mean that this is the beginning of another credit bubble – especially given the low delinquency rates in the sector. Indeed, credit growth as a whole is not likely to grow at the rapid rates seen early in the decade. After going through such a massive deleveraging cycle, consumers are likely of a different mindset, where they don't plan to run up as much debt. As well, regulations have become stricter for lenders, which should prevent a repeat of the latest crisis.

Finance companies seeing a larger bounce back

Within auto lending, banks account for nearly half of all loans, while finance companies make up the rest. Finance companies have seen a bigger bounce back over the last couple of years, with year-over-year growth sitting at 9%, compared to banks, where growth is sitting at about 5%. Bank lending, however, did not contract as much during the financial crisis, so it has less ground to make up. While banks typically have a less risky loan portfolio than finance companies, they have seen the largest growth in subprime lending relative to other types of lenders, up 13.5% y/y in the third quarter. Still, the overall share of subprime lending among banks remains at about a third.[3]

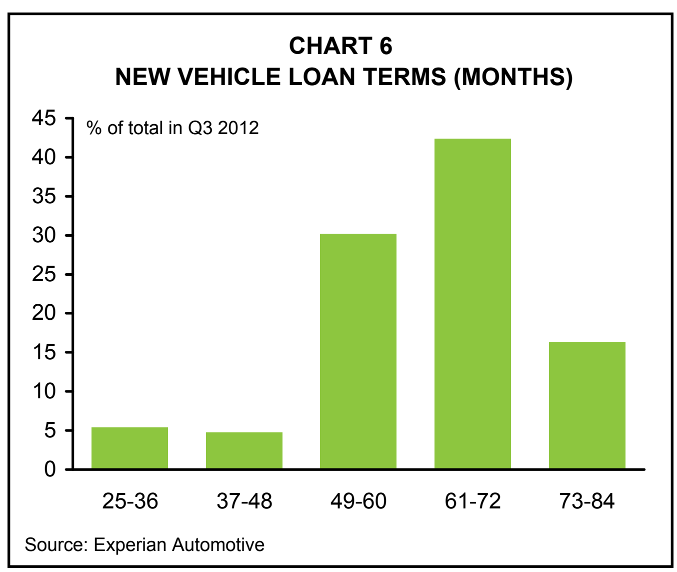
Affordability improving

Given all the different credit and payment options available for car buyers, it is not surprising that consumers are more concerned with the monthly payments rather than the price of a vehicle as a whole. This means that credit availability, the interest rates that lenders are willing to accept, and the different credit products offered will continue to be a key factor for consumers to consider when purchasing a vehicle. In fact, these factors can be used to increase vehicle affordability.

Leasing a vehicle reduces monthly payments relative to purchase financing, and the leasing market is slowly returning after slumping during the financial crisis. After falling to only 14% in 2010, the portion of vehicles leased has risen back to 24%,[4] which is more consistent with what has been seen over the past decade.

Perhaps the most common way in which consumers are lowering their monthly payments is by increasing the loan term. In the third quarter, the average loan term for a new vehicle was 64 months – up one month from a year earlier. In fact, over 40% of new vehicles are now financed for 61-72 months, while the 73-84 month range has seen the most growth and now accounts for 16% of all new vehicles financed. (See Chart 5) While some consumers are taking advantage of the lower monthly payments, others are using these tools to purchase a more expensive vehicle or to add features. Overall, average monthly payments have fallen slightly relative to year-ago levels, while the average amount financed has increased slightly.

All told, despite a steady rise in new vehicle prices, overall auto affordability has been improving over the past few quarters. According to Comerica's Auto Affordability Index, it took 23.1 weeks of median family income to purchase a new vehicle during the third quarter of 2012. While



the index shows that affordability has been improving since mid-2011, it remains below the peak level of about 22 weeks seen during the financial crisis.

While longer terms, looser credit conditions and lower interest rates are enabling consumers to purchase vehicles they would otherwise not be able to afford, it begs the question of how sustainable this is and whether the industry is setting itself up for issues down the road. The good news is that auto loans are typically locked in at a set interest rate for the duration of the term. So even once interest rates begin to rise – which isn't likely to happen before 2015 – the debt burden on consumers will remain low. On the other hand, if the umemployment were to rise due to job losses, even these lower monthly payments could soon become unaffordable for some, driving delinquency rates higher. The risk of this happening, however, is quite low at this point in the recovery cycle.

Where to from here?

The recent trends seen in auto finance are likely to remain intact going forward. While households are expected to stay somewhat cautious overall, auto credit is likely to record a further gradual recovery this year, likely in the mid-single digit range. This is consistent with our view for new vehicle sales of 15.2 million units in 2013. The new car market, however, is only part of the story. Used vehicle loans account for 60% of total auto loans, suggesting that this market played a key role in the performance of auto credit growth last year as well. While there is some substitution effect between new and used vehicles, several of the factors that are supportive for new vehicles will also be supportive of used sales this year. With overall auto sales expected to remain quite healthy, auto finance should continue to be a bright spot for lenders.

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Endnotes

[1] Woellert, Lorraine. "Relaxed lending, wider credit can propel U.S. car sales only so far, economists warn". Automotive News, November 14th, 2012.

[2] Zabritski, Melinda. "State of the Automotive Finance Market Third Quarter 2012". Experian Automotive, 2012.

[3] Ibid.

[4] Ibid.