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Non-Prime Times

Auto Finance Outlook 2020

Managing Risk in Non-Prime Portfolios

How Any Challenging Economy May Impact Lenders

CFPB: Actions Speak Louder than Words

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The Auto Finance Outlook for 2020

By Daniel Parry

It is common for auto lenders to spend the fourth quarter preparing for the coming year. This typically involves planning volume and yield targets, along with staffing and capital needs. The challenge this time around is that we are entering a presidential election year, which intensifies an already heightened level of uncertainty. For this reason, senior executives will be focused on important questions such as:

- Should we be growing, and at what pace?
- Will we have access to the capital markets?
- Are there risks to credit performance that we need to get ahead of?
- Where are recovery rates headed?

To answer these types of questions, lenders must consider how their capital partners perceive the lending environment in order to ensure they will be able to continue to fund the business. The vast majority of capital for the $700 billion in auto loans that are originated every year in the United States comes from the debt markets, which include warehouse lines and bonds. The set of strategies available to lenders is largely dependent on how these entities perceive the following key factors:

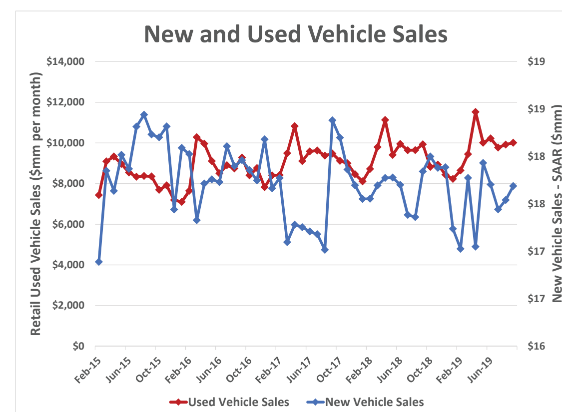
- **Competition** – The availability of capital combined the demand for autos and auto financing drives competition. Plentiful capital and shrinking demand mean that lenders will be fighting for every loan they put on the books and could be cutting corners in order to have a growth story.
- **Credit quality** – Portfolio performance is a lagging indicator, reflecting the quality of what was booked more than a year ago rather than what is happening today. Nevertheless, capital markets react to present state of delinquency and loss and will adjust accordingly. This could mean more expensive borrowing costs, reduced leverage or a contraction altogether.
- **Economic factors** – Economic risk involves more than just estimating the odds of a recession. Players in the capital markets will assess risks to the consumer's ability to pay on a number of fronts and will rotate investment to sectors where they can achieve the optimal balance of risk and return. This could mean a severe tightening of warehouse debt, and worse bond execution (i.e., higher cost of funds to the lender).

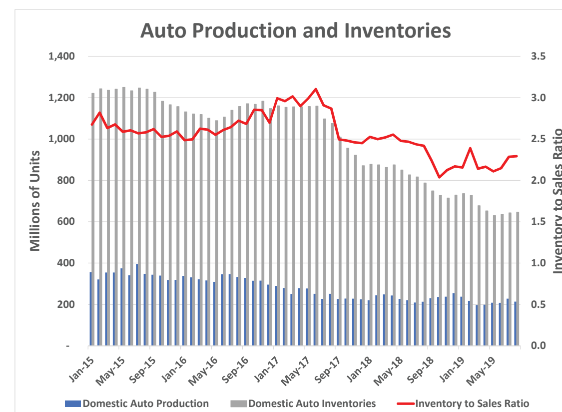
Competition

From 2009 to 2010, competition was a non-issue for auto lenders as capital was in short supply. Consequently, that period also boasts some of the strongest credit performance numbers across the spectrum as more than half of consumers were sidelined and lenders cherry-picked to fill their limited funding capacity. By 2015, things had changed substantially as many private equity-backed companies were trying to sell a growth story at a time when demand had leveled off.

By late 2016, some lenders that had over-reached on credit began to see delinquency and losses rise leading to speculation that there was an impending subprime auto bubble. This resulted in some sizeable lenders contracting in the subprime space, eliminating approximately $20 billion in available credit to consumers. What followed from this was a marked improvement in both delinquency and credit loss over the course of 2017 through 2019 (refer to the Experian State of the Auto Finance Market report for Q2 2019).

Experian also reveals that while open auto loan balances are still increasing, they are doing so at a reduced rate over prior years. At the same time, Fitch Ratings reports that both Subprime and





Source: Federal Reserve, U.S. Census Bureau Retail Auto Survey

Prime ABS issuance is up in 2019. Subprime auto, which has averaged in the low to mid $20 billion range for non-recessionary periods, will top $31 billion in 2019. In addition, a number of private equity firms that entered the space in 2011-2012 are still looking for an exit. If they see 2020 as their opportunity, the competitive environment may very well resemble that of 2015.

Going into 2020, we see that new and used vehicle demand has leveled off (refer to the graph titled New and Used Vehicle Sales), and that new vehicle production has declined as a result. Total vehicle inventories have been substantially reduced, resulting in a supply that meets current demand levels (refer to the graph titled Auto Production and Inventories). While some vehicle classes are faring better than others, the good news is that there is not a market-level oversupply of vehicles that will drive down recovery rates in the near future.

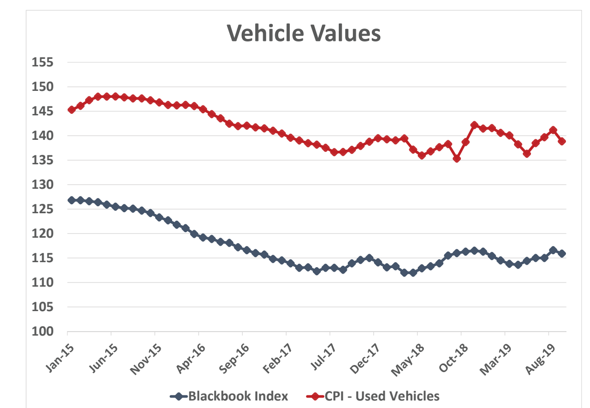
Credit quality

The overwhelming majority of credit performance news has been positive throughout 2019, both in prime and subprime. Experian and Trans Union both report that 30-day and 60-day delinquency has declined over the past two years. Furthermore, Fitch Ratings notes that 60-day delinquency and charge-offs are down both for prime and subprime bonds. Several of the major bond rating agencies have reported that 2017-2019 static pools are trending to the lowest levels in more than three years.

Recoveries have been on the rise as well, supported by the effective matching of inventory to demand by the manufacturers. While Manheim points to a slight softening in year over year wholesale prices, it should be noted that there was an unusual uptick in used vehicle values in the summer of 2018. As seen in the graph titled Vehicle Values, the Black Book Vehicle Retention Index and the Consumer Price Index for Used Vehicles show prices to have been relatively stable since demand leveled off at the end of 2016. Furthermore, the quarterly Experian Automotive presentation shows that lease volume is declining while Manheim reports that the volume of off-lease vehicles have peaked.

In late 2016 and early 2017, dealers had a glut of small to midsize vehicles on their lots. In response to this problem, manufacturers cut production on these units. Now, two to three years later, there is a shortage of these vehicles and they have shown improvement in value year over year at auction. Luxury cars and vehicles less than one year old have declined, while the remaining categories have shown improvement. This has resulted in a stabilization, or even improvement, in the recovery rates seen by subprime lenders.

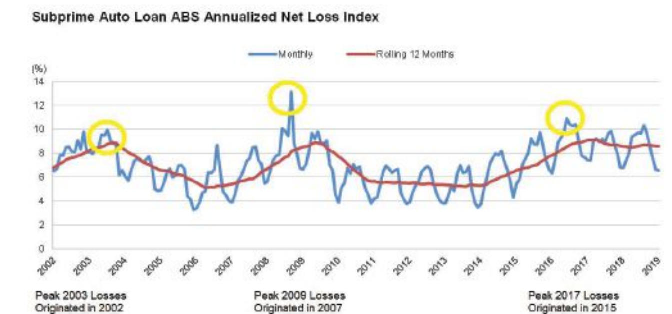
Credit performance, specifically in subprime, has been improving over the last two years in spite of the constant stream of financial



Source: Black Book, Federal Reserve

new warning of a meltdown. There have been a handful of notable exits in the last year, as well as isolated incidents of poor performance, but these do not represent systemic credit issues in subprime auto lending. Many of the exits have more to do with weary capital partners whose capital has been tied up too long than issues in performance.

While numerous reports on positive credit performance are encouraging, there are reasons to be concerned. Double-digit growth in loan volume is almost always followed by a deterioration in performance–which doesn't become apparent at the portfolio level for 12-18 months. Some of the lenders that



have resumed growth are already seeing performance issues on a static pool basis, as noted by recent rating agency reports.

As shown in the chart titled Subprime Auto Loan ABS Annualized Net Loss Index, losses hit peaks in 2003, 2009 and 2017 on a portfolio level; but, static pool analysis reveals that those losses

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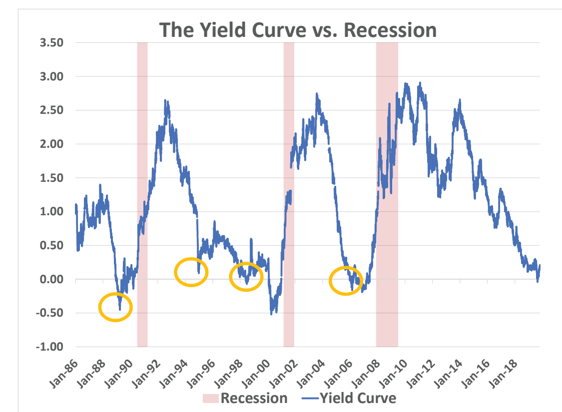
came from loans originated two years earlier. Given where credit performance sits at the end of 2019, we are unlikely to see a substantial deterioration in portfolio-level defaults over the next 12 months. However, a sustained spike in delinquency would send signals to the capital markets that things may be overheating.

Economic factors

Economist Edgar Fiedler once wrote, “The herd instinct among forecasters makes sheep look like independent thinkers.” He wrote this in 1977, but it is easily applicable today as economic forecasts are often too closely connected to one’s political affiliation. On one side of the aisle, all things are rosy. On the other side, people are looking for a recession under every rock. Wishful thinking aside, the important thing for auto lenders to consider is how capital providers think about the subject.

There are those who believe that recession forecasts are akin to something you would read from the Old Farmer’s Almanac. In other words, “recessions happen every 10 years, so we are due for one any minute.” In actuality, recessions have been tracked in the United States since 1790, and the time between them varies wildly. Recessions happen for reasons, and the underlying causes are what the capital markets are looking out for.

One metric people often turn to is the inverted yield curve, which in plain language means that the yield on short-term bonds is higher than long term bonds. Under normal conditions, longer terms produce higher yield and vice versa. An inverted curve



Source: Federal Reserve

suggests that investors do not have confidence in the long-term outlook and wish to be liquid sooner rather than later. This increases demand on shorter term instruments, which pushes up rates.

We experienced an inverted yield curve (which is defined here as the 10-year treasury bond rates minus the two-year treasury bond rates) approximately 12 to 18 months in advance the last three recessions. What is usually left out of this analysis is that there were many more times the yield curve either inverted or came close and a recession did not occur. The most that can be inferred from an inverted yield curve is that analysts and investors have a dim view of the future. The real question is “why is this the case?” Negative sentiment concerning markets is most often fueled by factors related to:

- **Manufacturing** – When companies are making things, and placing new orders for materials, it is because consumers are buying more. This is usually the result of strong employment and wage figures. Factors related to inventories, production, CEO sentiment and new orders are important to pay attention to. One of the most often cited statistics is from the Institute for Supply Chain Management’s Manufacturer’s Price Index (MFI). Whenever that value is over 50 it means the economy is growing. This index dropped significantly over the prior six months, following a rate increase by the Federal Reserve. In July and September of 2019, the Federal Reserve lowered rates, which was followed by a sharp uptick in the MFI. The index presently sits at 47.8 and is likely to be back over 50 in the coming months.
- **Consumer outlook** – When consumers have a positive outlook, they spend money. When they don’t spend money, manufacturing (and subsequently employment) contract. The Consumer Confidence Index has been on a steady increase since the last recession. Presently, the index sits at an 18-year high of 128.
- **Asset bubbles** – Investor exuberance often drives up prices beyond what an asset is worth. We’ve seen this recently in the housing crisis of 2007 and the dot.com bust in 2000. Asset bubbles can be tied to a consumer asset such as mortgages or auto, or a specific investment sector. Presently, auto and mortgage loans are nowhere near inflated levels, and increases in the stock market can be directly traced to a real increase in corporate earnings. One legitimate fear is related to student loans. Defaults have been steadily rising on the roughly $1.5 trillion outstanding, which has caused many banks offering private (non-government backed) student loans to exit the market. This bubble is not likely to burst in the coming year, and when it does – it pales in comparison to the $22 trillion in debt the federal government already carries.
- **Government controls** – Politicians, and the economists they rely on, like to believe that they can control the weather and alter physical laws through edict. They cannot, and when they try it often creates disastrous results. A case in point relates to price and wage controls implemented by Richard Nixon in 1970. Workers were laid off when companies could not adjust wages, consumer demand fell, and a recession ensued in 1973. In addition, there was a ripple effect that led to stagflation in the late 1970s. Trade wars related to tariffs are blamed as the cause of the 1929 stock market crash that led to the Great Depression. Tariffs and trade wars are once again a topic of concern, and several well-known experts have suggested that the present situation with China will hurt the U.S. auto industry.

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While that is certainly possible, my personal view is that the present administration will push hard until they achieve something they can paper up as a win. It is unlikely they will dig in so hard as to sink the markets in an election year. The most important thing to pay attention to as it relates to the federal government is what policies are doing to inflation or deflation. Both extremes lead to increased unemployment and eventually recession.

- **Credit performance** – Loose lending can impact many areas of the economy. It is not just the consumer who takes on more debt than is manageable, but all of the other entities that acquire consumer debt. For example, AIG purchased swaps on subprime mortgages that led to an $85 billion bailout in 2008. The $3.6 trillion money-market industry was heavily invested in AIG debt, and most hedge funds as well as financial institutions around the world owned AIG stock. Fortunately, as described in the previous section, credit performance in the auto sector is doing very well. TransUnion's Industry Insights Report for Q2 2019 also notes that performance in mortgage and credit cards are solid as well. While the overall credit outlook is positive, analysts are paying close attention to consumer debt levels. When lenders chase volume, they often cut corners on credit policy which results in over-burdened consumers. Presently, consumer debt is rising proportionately with wage increases; although, if the debt-to-income level of U.S. consumers begins to shift it will lend additional credibility to recession fears.

Planning for 2020

Most would agree that efforts to precisely predict economic and market conditions will be off to some degree, and the error increases in conjunction with how far ahead the prediction goes. However, Stanford University Professor Paul Saffo said, "The goal of forecasting is not to predict the future but to tell you what you need to know to take meaningful action in the present." With that in mind, auto lenders should consider the following as they plan for the coming year:

- **Grow with discipline** – Competition will increase, and it will be harder to book the same paper you are booking now. To prepare for this, it is imperative that lenders thoroughly understand their own costs and limit themselves to what they can book profitably–regardless of what the dealer says competitors may be doing. If you have not integrated a credit scoring model into your program, your ability to grow safely is impaired. Scores are not only good for managing credit, but also yield and closure rate.
- **Drive efficiencies** – Do a thorough analysis of what you spend on systems, data, credit bureaus, headcount, sales and marketing to understand what your cost per booked loan is. Many lenders incur between $800-$1,000 per closed deal in expense. Modest refinements to the credit program can increase closure and drive that figure to $300-$400 per closed deal (that is a savings of $4.8 million a year for a lender booking 500 contracts per month). These refinements include validating legacy policies and discarding those that inhibit growth. Furthermore, lenders must focus on components of the program that allow the dealer to make the most money. Look at integrating or improving collections models as well. Lenders who integrate these models for the first time typically see a 200-300 basis point reduction in roll rates in cycle-1 delinquency and a 30% reduction in collection expense. These efficiencies build internal capital, which benefits the lender in more ways that just being able to book more deals. It is about having enough cash in the business to give debt partners confidence that you can afford to properly service the portfolio (excess spread).
- **Get ahead of CECL** – Lenders will need to begin accruing for the new accounting standard in 2022. The guidance from regulators is that lenders should run three quarters of parallel processing prior to implementing CECL. This means they must have a vetted process in place by Q2 2021. That process will need to be built and tested in 2020 to ensure that the company is properly prepared. Some lenders will do this internally, while others will partner with consultants or use canned software tools. Lenders are not so much at risk of failing to have a "compliant" process around the provision, but they are at risk of over-provisioning by as much as 30 percent. The reason for this is that accountants and auditors are creating a process that relies on competent loss forecasting – which is an entirely different discipline than accounting. If you do not have a robust forecasting process internally, partner with people who can help you develop this important skill set.

The outlook for 2020 is largely positive. There is a reasonable risk of margin compression from intensified competition (which may also result in credit performance issues), but there are far more reasons to be optimistic about the coming year. These include continued stability in credit performance and a very strong economy. That being said, trade wars, conflict in the Middle East and presidential elections are likely to create somewhat of a circus environment over the next 12 months. Executives should remain focused and remember that capital markets are adept at seeing through the noise to the real risks. By paying attention to these risks, strong lenders will greatly improve their ability to secure continued access to capital regardless of what is going on in the broader market.

Daniel Parry is co-founder and CEO of TruDecision Inc., a fintech company focused on bringing competitive advantages to lenders through analytic technology. He is also co-founder and CEO of Praxis Finance, a portfolio acquisition company, and co-founder and former chief credit officer for Exeter Finance. If you have questions, you may reach Daniel at solutions@trudecision.com.

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