September 8, 2014

An Open letter to the U.S. Congress from the Consumer Credit Industry:
Motor Vehicle Finance Creates Opportunity and Drives Economic Growth

Over the past few weeks, some in the media have raised alarms comparing motor vehicle finance with the residential mortgage bubble nearly seven years ago. The comparison was quickly and persuasively discredited by the more sophisticated financial press[1] and analysts from organizations such as the credit-rating agencies.

Those of us involved in extending credit to vehicle buyers are writing to remind policymakers not just why auto loans are different from the mortgage lending we saw during the bubble, but also why the robust vehicle finance system in this country is so important to economic growth and personal well-being.

Vehicle Finance Drives Growth

The availability of vehicle finance contracted during the recent recession, as did most forms of consumer credit. But the auto market rebounded in a manner that has led the uneven U.S. economic recovery, largely due to the government's interest rate policies instituted with just this sort of outcome in mind. Pent-up consumer demand to replace an aging fleet has contributed to the upturn in economic growth.

Vehicle Finance Creates Opportunity

Vehicles are an essential part of everyday life for many people, whether for transportation to work, getting to medical appointments or simply going to the grocery store. Consumers from all walks of life need access to financing for a vehicle. An increase in subprime vehicle financing means that more working class Americans and those who have had financial difficulties in the past have access to transportation when they need it. This could make the difference between holding a job or not. Vehicle ownership provides many opportunities for consumers. Getting to and from work is critically important, and for millions it is impossible without personal transportation.

Vehicle Finance Exhibits Strong Performance

Current data shows that vehicle finance has performed well throughout the recession and continues to do so. According to a recent Equifax report, "despite record high balances, serious delinquencies on auto loans remain near all-time lows, representing less than 1% of total outstanding balances for the third consecutive month."[2] The S&P/Experian Consumer Credit Default Indices showed that the auto loan default rate hit a historic low in

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[1] Subprime auto loans' risk is acceptable, analysts say. Automotive News. 13 August 2014 <http://www.autonews.com/article/20140813/FINANCE_AND_INSURANCE/140819953/subprime-auto-loans-risk-is-acceptable-analysts-say>

[2] Equifax Reports Auto Loan Balances Hit All-Time High Mid-Way through 2014. Equifax. 24 July 2014. <http://investor.equifax.com/releasedetail.cfm?ReleaseID=861885>

April 2014, at 0.92 percent.[3] Thirty-day delinquencies are at their lowest level since 2007. Just this month, the Federal Reserve Bank of New York stated that the percentage of auto loan delinquencies of 90 days or more was "roughly flat at 3.3%."[4]

Outstanding balances in subprime auto credit have not returned to 2007 peak levels. While the near-prime segment (borrowers with credit scores from 620-699) has experienced some growth, prime borrowers have been driving the increase in auto lending. According to data from Experian Automotive, in the first quarter of 2014, the share of used subprime loans was lower than in the first quarters of 2013 and 2012.

The Vehicle Marketplace Does Not Resemble the Housing Bubble

Unlike many homes, a vehicle is a depreciating asset, and lenders calculate this loss of value into the risk of their financing. No one – from consumers to dealers to manufacturers to finance companies – believes that a car or truck will be worth more in the future. Thus, the talk of a bubble – which occurs when assets become overpriced based on a belief that they will continue to appreciate – in subprime auto is misguided. The mortgage bubble derived from this very notion, but the underlying fundamentals of automobile values mitigate a bubble.

Retail installment sale contracts on vehicle purchases are structured quite differently from residential mortgages and do not contain the exotic features that contributed to homeowner defaults. Vehicle finance products feature a fixed rate and a fixed term. Unlike in mortgages, retail installment sale contracts are "plain vanilla." While some automobile customers have subprime credit histories, there are no separate subprime products commonly used in vehicle finance. This market simply is not structured to encourage financial institutions to misprice risk. By contrast, the subprime products in housing finance were based on an unreasonable assumption of appreciating home values.

In particular, vehicle finance typically *does not* feature any of the following in either prime or subprime:

- Negative amortizing loans;
- Introductory teaser payments;
- "No-doc" or "low-doc" loans; or
- A built-in assumption of future refinance.

In the auto market, when securitizing assets the finance company remains in the first loss position and must focus on the risks. By contrast, prior to the recession, mortgage originators sold nearly every piece of the securitization, mistakenly believing they had transferred the risk to third parties. In addition, vehicle finance companies typically service the underlying loans in their securitizations, opposed to mortgage securitization, where the servicing could be transferred multiple times and where servicers had different risk perspectives.

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[3] S&P/Experian: Auto Defaults Dip to New Low. *SubPrime Auto Finance News.* 21 May 2014. <http://www.autoremarketing.com/subprime/spexperian-auto-defaults-dip-new-low>
[4] Quarterly Report on Household Debt and Credit. Federal Reserve Bank of New York. August 2014. <http://www.newyorkfed.org/householdcredit/2014-q2/data/pdf/HHDC_2014Q2.pdf>

Owning and Financing a Vehicle Has Never Been More Affordable

Improved vehicle quality and longevity is the principal factor driving longer loan terms. A recent study by Moody's Analytics showed that loan lengths and amounts are increasing, essentially equally, among both prime and subprime borrowers.[5]

In conclusion, significant and substantive differences exist between subprime auto finance and mortgages. These systemic differences were one major reason why there was no subprime auto crisis during the Great Recession. The reality of today's marketplace is that the auto sector continues to exhibit resilience as consumers continue to repay their loans.

The undersigned,

American Financial Services Association
Consumer Bankers Association
Financial Services Roundtable
National Automobile Dealers Association
National Independent Automobile Dealers Association
U.S. Chamber of Commerce

[5] DeRitis, C. Is U.S. Auto Lending About to Bubble Over? Moody's Analytics. 12 August 2014. <https://www.economy.com/dismal/article_free.asp?cid=249410&tid=5FCB4BBF-D759-422D-BD25-BFF7D505D457>