

Economics Group

Special Commentary

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Vehicle Detailing: Record Auto Debt & the Consumer

Executive Summary

Household debt is at a record high, but as a share of GDP it is way down from its 2008 peak. The lower debt share today suggests that households are in better shape. But when we look at the composition of household debt we find that nearly all the growth in household debt in this cycle has come from just two categories: student loans and auto loans. This report focuses on auto loans, an upcoming report will build on work we have already done on the student loan situation.

Consumers today are buying bigger, more expensive cars and they are financing them for much longer periods of time than even a few years ago. While the median credit score of borrowers is higher and banks are already tightening lending standards, the cost of ownership is proving to be onerous given elevated levels of auto loan delinquencies.

We are not overly worried at present, but the run-up in auto loans is a potential risk not only to auto sales but to consumer spending more broadly. An exogenous shock, like a surge in gasoline prices or sudden deterioration in consumer confidence, could slow the pace of auto sales or lead to even higher delinquency rates or both. For now though, consumer confidence is at a 6-month high and gas prices remain relatively low. On that basis, we expect the pace of auto sales to remain steady or perhaps slow slightly and delinquencies to remain in check.

We are not overly worried at present, but the run-up in auto loans is a potential risk.

Putting Auto Loans in Perspective

One of the major imbalances in the lead-up to the financial crisis and recession was sky-high levels of household debt. As a share of GDP, household debt peaked at 98.3% in the first quarter of 2008. In level terms, the amount of household debt outstanding today is more than \$1 trillion larger than its peak in 2008, but since the economy has grown much faster than household liabilities, the share of household debt relative to GDP has come down to just 74.2% (Figure 1).

Figure 1

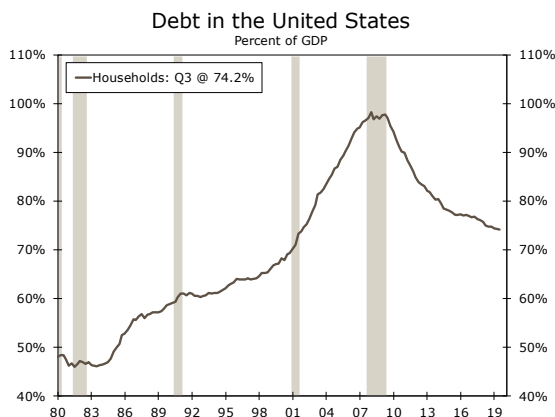
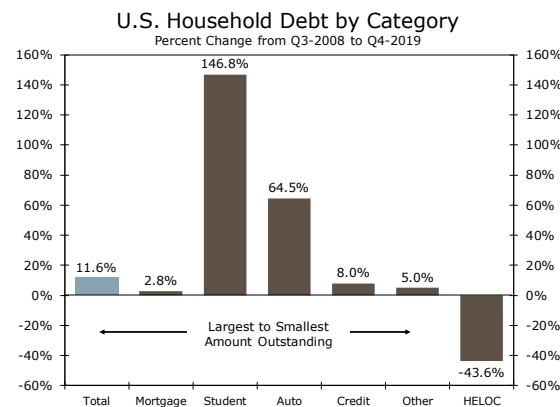


Figure 2



Source: Federal Reserve Board, Federal Reserve Bank of New York and Wells Fargo Securities



Auto loans represents the third largest category of household debt.

The lower debt share today suggests that in aggregate at least, households are in better shape. But when we look at the composition of household debt, we find nearly all of the growth this cycle has come from just two categories: student loans and auto loans.

To put the category in perspective, the \$1.3 trillion in auto loans represents the third largest category of household debt (after mortgages and student loans). As a share of the total, auto loans comprise 9.4%. While the growth in student loans has grabbed most of the attention this cycle, it bears noting that the 64.5% growth in auto loans towers over the growth in the next fastest-growing category, credit cards, which is up only 8.0%.

OK, So It’s a Big Driver of Household Debt, Is it a Problem?

The fact that auto loans are up significantly does not necessarily mean they are a problem. The question is whether or not the borrowers are in decent financial shape and in a good position to stay current on payments. Just hearing the words “subprime” can conjure up bad memories of the financial crisis, and the overly sanguine assessment of the risk that sub-prime mortgage loans presented to financial markets. Is there a subprime problem in the auto loan market today?

The Consumer Financial Protection Bureau, a government watchdog, considers a subprime score to be between 580 and 619. In Figure 3, we have plotted auto loan originations by credit score. The subprime share is the yellow color at the bottom of the mountain chart.

One of the points this chart makes is that sub-prime originations have not changed meaningfully over the past three years or so and remain below their pre-recession peak. In fact sub-prime originations are not keeping pace with growth in higher credit categories.

Our colleagues who do research on structured products like Asset-Backed Financing (ABF), which packages portfolios of auto loans for investors, have pointed out that the decline in subprime auto loan originations is an encouraging sign. This is because lenders have ramped up originations to more credit-worthy borrowers in recent quarters. The last time subprime auto loan growth outpaced prime was in early 2015, and lenders subsequently experienced higher-than-expected loss rates and had to tighten underwriting standards, they point out.

Another way of taking the pulse of the auto loan market is to look at the median credit score which we have plotted in brown in Figure 3. The median credit score has been trending higher in recent years and at 715, that figure is spitting distance from its high right at the end of the recession in 2009 when most auto lenders were thinking more about repossessing vehicles than they were about making credit available to new borrowers.

The median credit score is spitting distance from its high at the end of the 2009 recession.

Figure 3

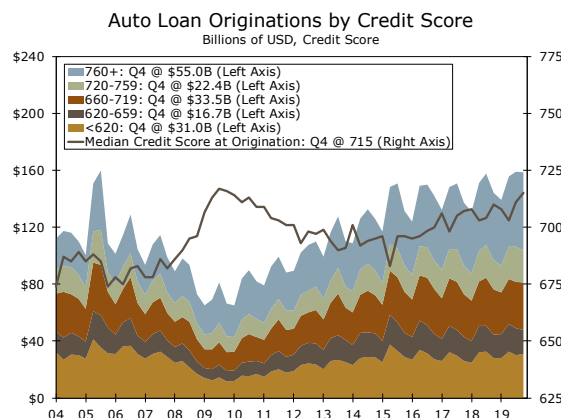
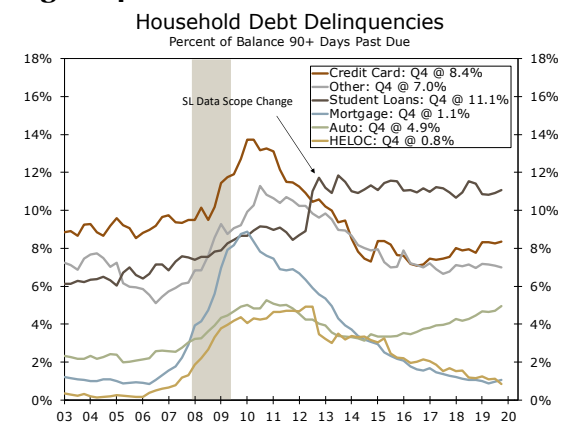


Figure 4



Source: Federal Reserve Bank of New York and Wells Fargo Securities

But if credit standards have been so impeccable, we would expect to see borrowers having no difficulty keeping up with their payments, and that is clearly not the case. A loan is generally

considered delinquent when it is 90 days past due. Delinquency rates for various credit types are plotted in Figure 4.

The glass-half-full reading of this chart is that auto loan delinquencies are lower than those of student loans, credit cards and mortgages. But at 4.9%, the delinquency rate for auto loans is the highest since the third quarter of 2011, and less than 0.4 percentage points below where it was at its 2010 peak.

The delinquency rate for auto loans is nearing its previous peak.

Tighter Lending Standards

Mark Twain once famously quipped that a banker is someone who lends you an umbrella when the sun is shining but wants it back when it starts to rain. Aside from the credit score of originations, what is going on with the willingness of banks to lend?

Figure 5

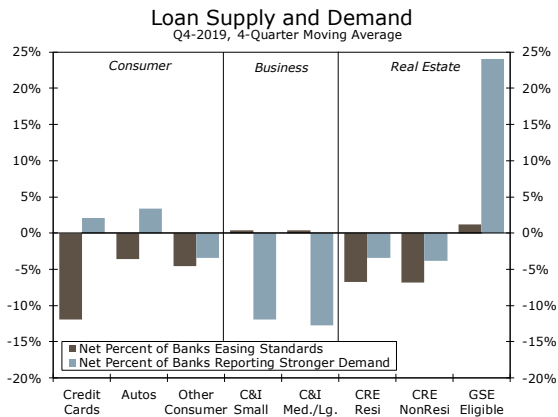
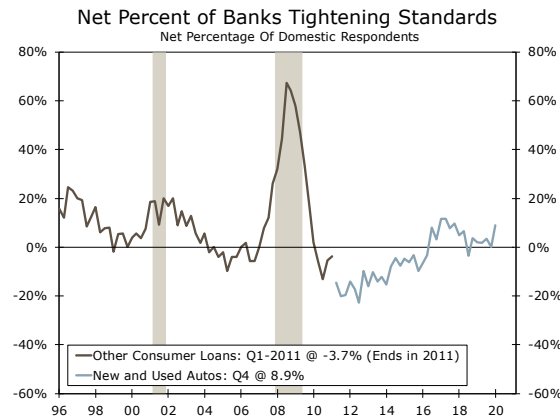


Figure 6



Source: Federal Reserve Board and Wells Fargo Securities

Through the fourth quarter of last year, the big story in lending is surging demand for mortgages, but if we look at the auto market we find there is still plenty of demand for financing (Figure 5). Although amid the backdrop of rising delinquencies, banks are tightening lending standards in that space.

The tighter lending standards do not represent a sudden about-face in lending standards however. Figure 6 shows a time series of bank lending standards for new and used auto loans and reveals that financing has been getting tighter for the better part of the past three years.

Seven Years Stretched & the Disappearance of Cars

You do not have to be too old to remember a time when the payback period for a typical auto loan was 48 months. But in the lead-up to the recession, one of the ways that lending terms loosened for borrowers was longer payback periods. In 2007, according to data from the Federal Reserve, the average loan-to-maturity period for new auto loans shot up to 66 months (Figure 7).

A factor to consider amidst the run-up in auto loans this cycle is that the number of vehicles has not increased dramatically, but the price of vehicles has. In January, the annualized pace of auto sales came in at 16.8 million; the 2005-2007 average was 16.5 million.

The number of vehicles has not increased dramatically, but the price of vehicles has.

The average new vehicle market value before the recession was under \$30,000. In November 2019, the average vehicle cost \$38,822, according to Edmunds. A typical vehicle today is likely to have more in the way of expensive technology and driver-assist features than a decade ago, but the bigger difference is the emergence of SUVs and crossovers amid the plunge in sales of ordinary sedans.

Figure 7

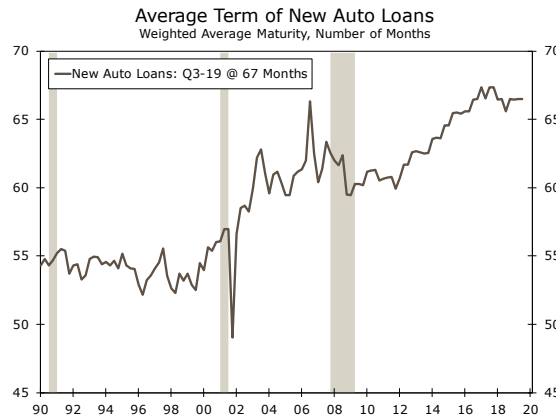
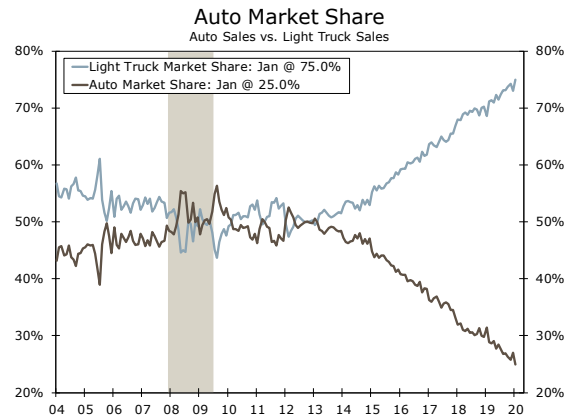


Figure 8



Source: Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Securities

High gasoline prices and lower consumer confidence after the recession put more new buyers behind the wheel of a car as opposed to something in the light trucks grouping, a category that includes not only pick-up trucks but increasingly SUVs and many crossovers. Starting in about 2013 a stunning bifurcation began which continues to this day (Figure 8). After roughly an even split as recently as seven years ago, the light trucks category today commands three quarters of the auto market leaving just one buyer out of every four leaving the dealer lot in a new car.

Bottom Line

Consumers today are buying bigger more expensive cars, and they are financing them for much longer periods of time than they were a few years ago. The median credit score of borrowers may be higher and banks may be trying to tighten lending standards, but the cost of ownership is proving to be as onerous as it has in years given the elevated levels of auto loan delinquencies.

We are not overly worried at present, particularly given the near-record high median credit score of recent borrowers. That said, we see the run-up in auto loans as a potential risk not only to auto sales but to consumer spending more broadly. An exogenous shock like a surge in gasoline prices or sudden deterioration in consumer confidence could slow the pace of auto sales or lead to even higher delinquency rates or both. For now though, consumer confidence is at a six-month high and the national average price for a gallon of unleaded gasoline is below \$2.50, down from \$2.89 in May of last year. We expect the pace of auto sales to remain steady or perhaps slow slightly and delinquencies to remain in check.

Banks may be trying to tighten lending standards, but the cost of ownership is proving to be onerous.

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