Understanding automotive loan charge-off patterns can help mitigate lender risk

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Executive Summary

Loan delinquency rates are one of the most important statistics to track in the automotive finance industry. If consumers are not repaying loans on time, it puts billions of dollars at risk. When high dollar volumes are at risk, it is a negative for everyone in the lending world, including consumers, automotive retailers and lenders themselves.

When lending markets crashed in the fourth quarter of 2008, it caused chaos for the industry. While conditions have improved considerably the past few years, lenders still need to remain vigilant about where delinquencies are most likely to occur. It's an unavoidable fact that some loans will have to be charged off. But, understanding where and how these charge offs occur provides important learning for the industry.

Experian Automotive has found several clear patterns that can help lenders better understand the root cause of loan delinquencies. These can be found in vehicle buyers themselves through credit scores and length of credit history; through the vehicles themselves and their own history; and through the loans themselves by understanding the impact of high loan-to-value (LTV) ratios.

All of these data points provide insight into patterns of where charge offs are most likely to occur and can significantly impact the strategies lenders adopt.

Source: North American Vehicle Database, Q2 2010

In this study, Experian Automotive reviewed its North American Vehicle Database sourced from Departments of Motor Vehicle title registrations for new and used loan financing (model year 2006+ on used financing). Loans reviewed were initiated in Q2 2010 and tracked through December 2011. This included 1,352,388 new vehicle loans and 1,295,289 used vehicle loans for a total of 2,647,677.

Among the key findings:

- Loan term had little impact on overall loan attrition. However, longer term loans were significantly more likely to end with loans being charged off
- Used vehicle loans charge off at a rate almost double to the rate of charge-offs for new vehicle loans
- Customers with longer credit histories have charge-off rates significantly lower than customers with brief credit histories
- Loans on vehicles with negative automotive history are 1.47 times more likely to charge-off than "clean" vehicles
- Loans that are charged-off typically start with much higher loan-to-value ratios than industry averages

Longer terms = higher charge-offs

Longer term loans are growing in popularity. In Q4 2011, loans from 73 to 84 months in length grew by more than 40 percent compared with Q4 2010. While this will help consumers get a more expensive vehicle for a lower monthly payment, it could be a high-risk strategy for lenders.

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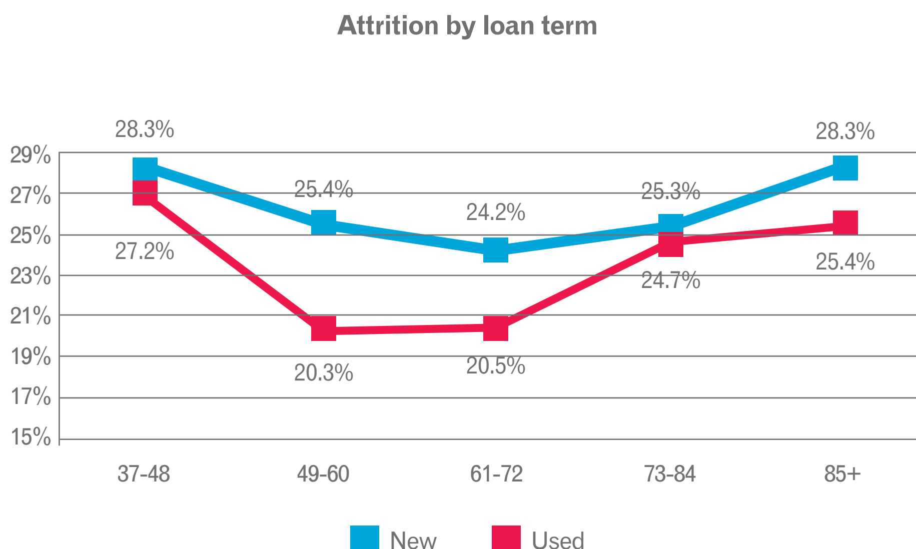
The attrition rate for longer term loans has little variance for both new and used vehicles. For used vehicles, the 85-plus month loans had an identical attrition rate (28.3 percent) to the 37 to 48 month loans. For new vehicles, the 85-plus month loans had an attrition rate of 25.4 percent compared to an attrition rate of 27.2 percent for the 37 to 48 month loans.

Attrition by loan term



However, the charge-off rates for longer loan terms are dramatically higher. For new vehicle loans with terms from 73 to 84 months, the charge-off rate is 1.5 percent. This is nearly seven times the charge-off rate for loans from 49 to 60 months (0.28 percent) and nearly 15 times the charge off rate for loans from 37 to 48 percent (0.11 percent).

The differences in charge off rates for used vehicle loans with longer terms are not as drastic, but still significant. For used vehicle loans from 73 to 84 months, the charge off rate was 2.03 percent – more than double the charge-off rate for used vehicle loans from 49 to 60 months (0.96 percent) and more than 40 percent higher than loans from 37 to 48 months (1.42 percent).

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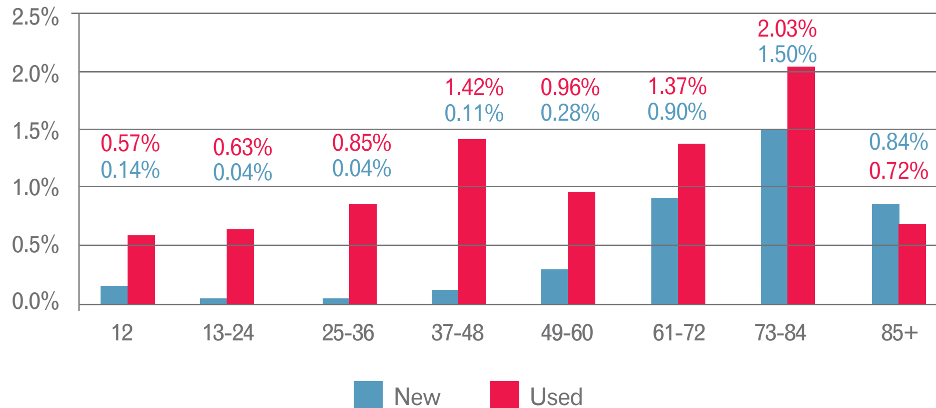

Length of credit history a strong predictor of potential charge-offs

There is a clear correlation between the length of time someone has had a credit history and the likelihood of a new or used vehicle loan going bad. Customers who are in their first year with credit history are five times more likely to have a charge-off than customers who have a credit history of 10 years or longer.

Overall, 3.02 percent of vehicle loans to people with 13 to 24 months of credit history end up being charged-off, compared to just 0.60 percent for people with 121 months or longer credit history. This holds true for both new and used vehicles. For used vehicles, 3.45 percent of loans in the 13 to 24 month category go bad, compared to 0.78 percent for loans in the 121 month or longer category. For new vehicles, it is 1.85 percent for new customers and 0.44 percent for established customers.

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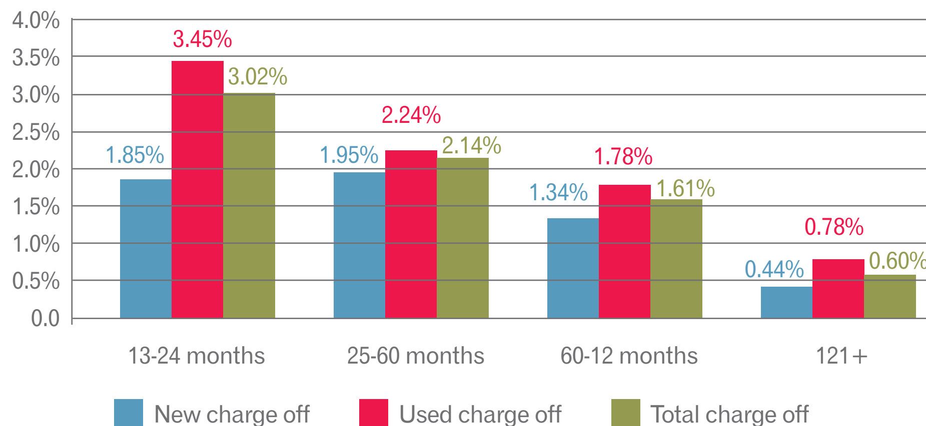

Customers with longer credit histories tend to be older and have had more time to build up a financial safety net. If tough times hit, they are much more likely to weather the financial storm. Those just starting out are much less likely to have built up cash reserves that can help them get through a rough patch.

Of course, a negative credit history is still one of the best predictors of future behavior. Customers in the deep subprime risk tier default on new vehicle loans at a rate of 3.77 percent and used vehicle loans at a rate of 3.83 percent. This makes deep-subprime customers approximately 20 times more likely to default on a loan than customers in the super prime category, who default on 0.14 percent of new vehicle loans and 0.17 percent of used vehicle loans.

Overall, used vehicle loans are nearly twice as likely to result in charge-offs than new vehicle loans, at rates of 1.03 percent and 0.57 percent, respectively.

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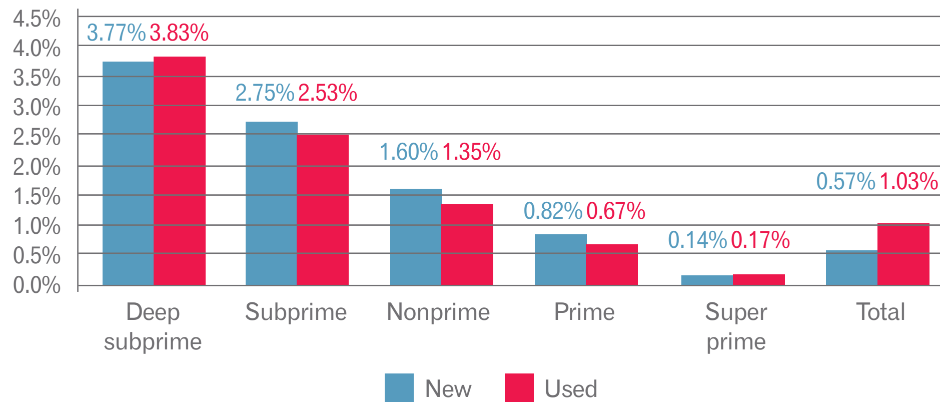

Vehicle history can impact charge-off rates

While most predictors of loan charge-offs are related to customers, the vehicle itself also can be an indicator of whether a loan will go bad. Vehicles with title brands are 1.47 times more likely to go bad than are loans for "clean" vehicles.

The most likely types of title brands that can lead to charge-offs include:

- Recycled, which is more than 10 times more likely to lead to a charge off than a vehicle with a clean title
- Major Damage Incident, which is seven times more likely to lead to a charge off than a vehicle with a clean title
- Title Damage, which is nearly four times more likely to lead to a charge off than a vehicle with a clean title

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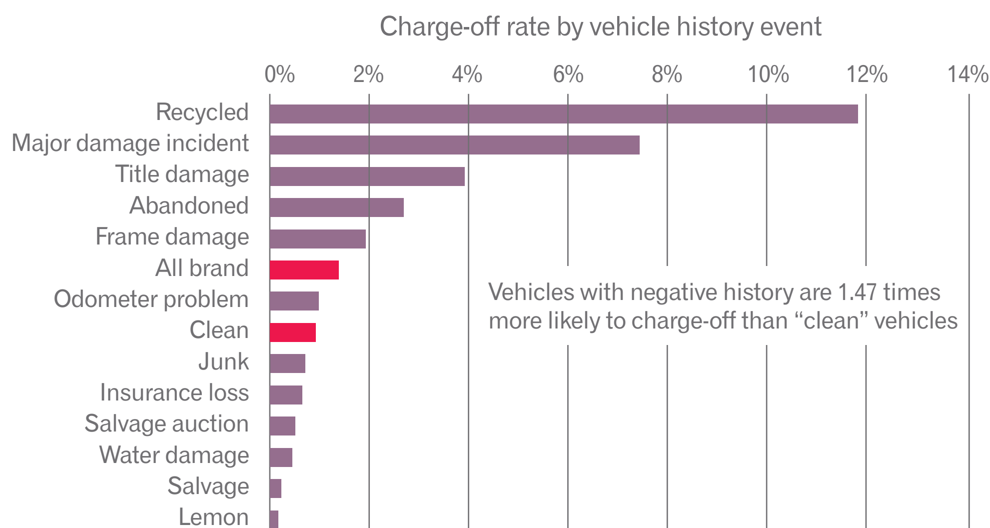

Charged-off loans start with higher loan-to-value ratios

Another predictor of potential charge-offs comes from the loans themselves in the form of high loan-to-value ratios. The average LTV ratio for new vehicle loans is 98.07 percent. For new vehicle loans that end up in charge offs, average LTV is 121.71 percent. For used vehicles, average LTV for all loans is 125.06 percent, while the average LTV for loans that end up in charge offs is 148.35 percent.

This trend is not limited to only consumers with bad credit. In fact, it is even more prevalent in lower-risk tiers, in part because lenders are willing to provide loans with higher LTV ratios to customers with good credit.

For new vehicles, the average LTV ratio on loans resulting in charge-offs in the deep subprime category is 112.09 percent compared to an average LTV ratio of 103.85 percent for all loans. In the Super Prime category, the average LTV for a charged-off loan is 126.84 percent compared to 93.85 percent for all loans.

For used vehicles, the average LTV for charged-off loans in the deep subprime category is 148.35 percent compared to 125.06 percent for all loans. In the Super Prime category, the average LTV for a charged off loan is 152.54 percent compared to 117.62 percent for all loans.

Conclusion

There is no question that the lending industry has gone through a solid period of recovery and is on much more firm ground today than when the markets nearly collapsed in the fourth quarter of 2008. Consumers are doing a better job of paying off their loans in a timely fashion, and that's good news for the entire industry.

However, when charge-offs are closely analyzed, clear patterns emerge that can help the industry continue to make sound lending strategies and create an even stronger lending environment. Some of the warning signs for potential trouble in lending:

- Longer term loans — given that these loans default at a much higher rate than shorter term loans, an over-reliance on loans greater than 72 months could spell trouble for the industry
- Credit history both in terms of length of credit history and risk tier provides an excellent barometer for loan success
- Vehicles themselves hold clues to loan success. Leveraging AutoCheck® vehicle history reports can help identify these vehicles at the inception of a loan
- Loan-to-value ratios that go significantly higher than 100 percent should be monitored closely as they are a significant source of charge-offs

Lenders that take these factors into consideration will likely give themselves an edge over those that do not.

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