Subprime Auto Loans: The next Shoe to Drop?

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Booming auto sales have more to do with low rates and easy financing than they do with the urge to buy a new vehicle. In the last few years, car buyers have borrowed nearly $1 trillion to finance new and used autos. Unfortunately, much of that money was lent to borrowers who have less-than-perfect credit and who might not be able to repay the debt. Recently there has been a surge in delinquencies among subprime borrowers whose loans were packaged into bonds and sold to investors. The situation is similar to the trouble that preceded the Crash of 2008 when prices on subprime mortgage-backed securities (MBS) suddenly collapsed sending the global financial system off a cliff. No one expects that to happen with auto bonds, but story does help to illustrate that the regulatory problems still haven't been fixed.

In a recent article in the *Wall Street Journal,* author Serena Ng uses the performance of a bond issue called Skopos Auto Receivables Trust to explain what's going on. She says:

> "The bonds were built out of subprime auto loans and sold in November. Through February, about 12% of the underlying loans were at least 30 days past due, a third of which were more than 60 days delinquent. In another 2.6% of loans, borrowers had filed for bankruptcy or the vehicles had been repossessed." ("Subprime Flashback: Early Defaults Are a Warning Sign for Auto Sales", Wall Street Journal)

Check out those dates again. If a loan, that was issued in November, is 60 days delinquent by February, it means the borrower never even made the first payment on the debt. How can that happen unless the lender is deliberately fudging the underwriting to "slam the sale"?

It can't, which means that dealers are intentionally lending money to people they know won't be able to pay them back.

But why would they do that?

It's because they know they can offload the crappy loans on Mom and Pop investors looking for a slightly better rate of return than they'll get on ultra-safe US Treasuries. That's the whole nine-yards, right there. Selling vehicles is just a cover for the real objective, which is creaming big profits off toxic paper that will eventually sell for pennies on the dollar. *Ka-ching!*

The problem is NOT subprime borrowers who pay much higher rate of interest on their loans than more creditworthy customers. The problem is dodgy lenders who game the system to line their own pockets. That's the real problem, and the problem is getting more serious all the time. According to the *WSJ:*

> "The 60-plus day delinquency rate among subprime car loans that have been packaged into bonds over the past five years climbed to 5.16% in February, according to Fitch Ratings, the highest level in nearly two decades. The rate of missed payments is higher for loans made in more recent years, a reflection of more liberal credit standards and the larger number of deals from lenders serving less creditworthy customers, according to Standard & Poor's Ratings Services…
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> "What's driving record auto sales is not the economy, but record auto lending," said Ben Weinger, who runs hedge fund 3-Sigma Value LP in New York and who has bearish bets on some auto lenders. He said demand for auto debt has led lenders to systematically loosen underwriting standards, which he predicts will result in higher loan delinquencies." (WSJ)

"Liberal credit standards"?? Is that what you call it when you lend thousands of dollars to someone who someone who doesn't have a job, an address or a credit card?

Sheesh.

While it's true that delinquencies are rising, it's not true that subprime borrowers don't pay their bills. They do, in fact, subprime lending can be extremely lucrative provided lenders do their homework. But when a lender is merely the middleman in a larger transaction, (like when the debt is bundled into a bond and sold to Wall Street) he has no incentive to make sure that everything checks out. His goal is to grind out as many loans as possible and let the investor worry about the quality. After all, what does he care if the loan blows up or not? It's no skin off his nose.

Keep in mind, the auto dealers really clean house on these garbage loans too. The average rates on these turkeys exceed 20 percent while loan duration typically lasts for about 6 years. That's a serious chunk of money drained directly from the paychecks of the poorest and most vulnerable people in society; the same people who are stuck forever in low-paying service sector jobs that barely pay enough to keep food on the table or gas in the tank. These are the victims in this loan-sharking swindle, the people who desperately need a car to get to work to feed their kids, and then find themselves shackled to a long-term obligation that just makes matters worse. Here's more from the *WSJ:*

> "Before making loans, Skopos said it verifies information, including borrowers' employment and whether they actually made cash down payments. For those with no credit score, it looks at alternative metrics, like how they pay phone bills. "We interview every customer before we fund the loan," Skopos CEO Daniel Porter said, adding that individuals with no credit histories are often young working adults who are more motivated to keep making payments."

They check to see if they pay their phone bills? That's what they call "underwriting"? What a joke!

By now you're probably wondering how this whole subprime nightmare resurfaced just 8 years after Wall Street blew up the financial system? Wasn't Dodd-Frank supposed to fix all that?

Sure, it was, but the powerful auto lobby in Washington managed to carve out a special exemption for themselves that allows them to shrug off the new reforms and continue the same risky behavior as before. That's why this auto-loan scam has morphed into a ginormous Hindenburg-like bubble that poses a looming threat to financial stability. It's because the big money guys twisted a few arms on Capital Hill and got what they wanted. Money talks. Here's more from the *WSJ:*

> "Banks had $384 billion of auto loans on their books at the end of last year, but households had auto-loan balances of over $1 trillion, according to Federal Reserve data. Indeed, Fitch Ratings warned last week that delinquencies of over 60 days on securities backed by subprime auto loans hit almost 5% in January. That is the highest since September 2009 and close to the record peak hit that same year.

Rock-bottom interest rates and record-breaking car sales have combined to put auto lending into overdrive, making some skids inevitable. While those should be more than manageable for the banking system, individual firms that went too fast into the curve by lowering underwriting standards may have a rougher ride." ("Why Auto Lenders Are in for a Rougher Ride", *Wall Street Journal*)

You know what comes next, don't you? The delinquencies start piling up, the finance companies begin to creak and groan, the banks and other counterparties hastily selloff assets to try to stay afloat, and, finally, the Fed rides to the rescue with another batch of emergency loans to prevent the whole wobbly, over-leveraged system from crashing to earth.

Of course, we could just pass legislation that made it a criminal offense to intentionally issue loans to anyone who fails to meet strict, government-approved underwriting standards. But then we'd never have these excruciating economy-busting financial crises anymore.

And what fun would that be?

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