Subprime Auto Lending
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Introduction
In March 2023, as the collapse of Silicon Valley Bank and First Republic Bank dominated the financial news, American Car Center (ACC) - a lender offering loans for used cars to customers with troubled credit histories - quietly collapsed. ACC abruptly closed its 40 dealerships across the southern United States and filed for Chapter 7 bankruptcy in Delaware. In April, another lender called U.S. Auto Sales (UAS) also collapsed, shuttering dozens of dealerships in several states. Like SVB and First Republic, ACC and UAS were unable to withstand a hike in interest rates by the Federal Reserve, which limited their borrowing capabilities. Coupled with inflationary pressures, their subprime borrowers were unable to make payments on their car loans.

Caught between a rock and a hard place, the lenders had no choice but to shutter. However, the impact that these failures will have on borrowers, and what they indicate about the Federal Reserve’s “higher for longer” interest rate strategy, remains uncertain.

Borrowers and Lenders both feel Interest Rates and Inflationary Pressures
From a borrower’s perspective, rising interest rates and inflationary pressures push delinquency on loans. Surpassing levels last seen during the Great Recession of 2007-2008, delinquency rates on auto loans by 60+ days past due rose 26 basis points from 1.43% in Q1 2021 to 1.69% in Q1 2023, with the spike in delinquencies impacting independent lenders with ACC and UAS who operate in the subprime space and primarily lend for used-vehicle purchases. These subprime used vehicle loans typically already carry high rates, starting at APR of 18.49% for subprime borrowers (with a credit rating between 500 - 600) and 21.38% for deep subprime borrowers (with a credit rating of less than 500). In a belt-tightening economy, this is a tough ask as prices for everyday goods, including gas, and other forms of consumer debt and lending, like credit cards, continue to rise. It’s also a tough ask for the asset side of a lender’s balance sheet.

From a lender’s perspective, like ACC and UAS, higher interest rates affect both the asset and liabilities side of their balance sheets. Subprime auto lenders aren’t just in the business of making loans to drivers, they also securitize loans - packaging individual loans together into asset-backed securities (ABS), similar to a typical mortgage-backed security - and sell these to investors on the financial market. Just like foreclosures tank the value of mortgage-backed securities, defaults on subprime auto loans cause these

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asset-backed securities to go bad. As interest rate hikes drive up the cost of borrowing, it can become increasingly difficult for investors and loan originators to cover their losses from these securities going bad. In this way, rising interest rates drive an even tighter squeeze on subprime auto lenders because securities are just as sensitive to interest rates and inflationary pressures as the loans that back them. When it comes time to cover losses, lenders have no ability to borrow and no opportunities to sell their assets at or above par value.

**Safe Assets and Interest-Inflationary Risk**

These vulnerabilities to “higher for longer” interest rates also drove the collapse of Silicon Valley Bank, as it had to liquidate assets - mostly held-to-maturity treasury bonds and agency mortgage-backed securities - for below par value in order to meet its obligations to depositors who ran on the bank. The dire straits that SVB, ACC, and UAS found themselves in resulted, however, from what participants in the financial market would typically think of as “safe” assets: U.S. Treasury bonds with long maturities. SVB didn’t hedge against interest rate risk as much as they should have because these bonds are perceived to be safer than their other assets, which were mostly loans made to start-ups and fledgling technology companies. Likewise, subprime auto lenders attempted to downsize their risk exposure by aggregating their loans into asset-backed securities and selling those securities to investors.

A deterioration of incentives for “safe” lending and borrowing practices is of great concern to regulators, who are now confronted with restoring confidence in their ability to uphold their end of the regulatory bargain. Keeping interest rates higher for longer can hurt the bond market, and failing to effectively curb inflation can inflict pain on both borrowers and lenders. Auto loans, uniquely, also have compounding effects arising out of their interconnection with employment rates, commodity prices, and public infrastructure in a high-rate and inflationary economy. As employment remains high, for instance, commuters rely on their cars to get to and from jobs that are becoming increasingly concentrated in urban areas - where the cost of living often exceeds the capacity of the average retail or service worker’s paycheck. As cities struggle to maintain public transportation infrastructure, monthly budgets come under strain as commuters become more sensitive to fluctuations in gas prices. Commuters have little choice over whether to fill up their tank so they can get to work, pick up their kids from school, or bring home groceries from the supermarket - where the price of everyday goods like eggs have more than doubled from 2022 to 2023. What happens, then, when borrowers start to default and lenders start to fail?

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8 David Gura, “Bond markets are being hit hard — and it’s likely to impact you,” NPR, October 24, 2023.
Another concern for regulators is the widening of the “credit gap,” the way that transactional debt - from credit cards, check cashers, and payday loans - carries a higher premium for borrowers with poor credit that leads to greater socioeconomic inequality. For instance, subprime auto loans often carry with them terms that limit the borrower’s ability to build equity, or an ownership interest, in their vehicle until the loan is mostly or fully paid off. If a borrower were to be delinquent or default, therefore, they could be left quite literally on the side of the road - and holding a very expensive bag.

Risks from a tumultuous market for subprime loans - as lenders fail and rates stay high - are further passed on to borrowers. Loan values - the total amount borrowed - fall as monthly payments - including interest - rise alongside lending terms that penalize delinquency, or restrict a borrower’s options when faced with default. Should the prerogative of regulators, then, be to shield subprime borrowers from being penalized by high rates and restrictive terms through borrower-focused regulation, or to reduce overall risk in the market through lender-focused intervention?

Unfortunately, the Federal Reserve, which would typically shoulder the lender-focused prerogative, doesn’t seem to show any indication of changing its course on interest rates anytime soon, leaving borrower-focused regulators like the Consumer Financial Protection Bureau (CFPB) to carry the burden of protecting subprime auto loans. In January 2023, the CFPB and the New York Attorney General took court action against Credit Acceptance Corporation (CAC), accusing the subprime lender of “tout[ing] its loans as a way for consumers to build their credit and gain financial freedom” while, unbeknownst to borrowers, imposing “predatory” terms on their subprime loans for used cars. This action came only a few months after the CFPB reported a skyrocketing in new vehicle prices resulting from supply-chain issues during the COVID-19 pandemic and issued guidance to low-income borrowers on securing loans for used cars. While these efforts have rightfully aimed toward protecting consumers, they remain ineffective beyond merely mitigating the pain that borrowers endure for being on the far side of the “credit gap.” More effective remedies may include leveraging regulatory authority that target the risks underlying the crises faced by lenders (i.e., disproportionate exposure to interest rates and inflationary pressures) or insulate lenders from these risks.

Insulating lenders from interest rate and inflationary risks is a much more complicated endeavor than tackling these macroeconomic circumstances head-on, but it could yield more long-term resilience and stability in the financial system. Under one approach, the burden of these regulatory interventions could be on the market level; for instance, using quantitative easing (QE) approaches to support markets for asset-backed securities originating from consumer loans, just as regulators have for mortgage-backed

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14 Chris Kukla and Ben Litwin, “Market monitoring insights: Examining the potential credit impact of high vehicle costs for consumers,” CFPB, September 19, 2022.
securities when lenders are squeezed. Under another approach, lenders could assume more of the burden by increasing their capital requirements or by increasing their liquidity requirements.

Federal Reserve officials have said for more than a year that beating inflation could require them to hold interest rates higher for longer than investors expected, with current rates of 5.25% - 5.5% being “sufficiently restrictive to get to our 2% target” according to Atlanta Fed President Raphael Bostic. As higher for longer rates start to take a toll, not only could the consensus of the Fed’s Board of Governors be shaken, but so could confidence in the economic outlook for millions of Americans just trying to get by.