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How Worsening Auto Finance Conditions Could Affect Banks, Nonbank Finance Companies, And Captive Finance Companies

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U.S. auto loans and leases have risen steadily over the past several years to reach all-time highs in 2016--facilitated in part by loosening underwriting. This has raised questions about whether the growth will ultimately lead to significant asset quality deterioration and increased depreciation on leases, as well as which lenders will bear the impact. Along with this, subprime auto delinquencies have climbed recently, and used-car prices have declined somewhat.

S&P Global Ratings believes the greatest areas of market and credit risks are leasing and nonprime (including subprime) lending, respectively, and the financial institutions with significant concentrations in those areas, or in auto finance in general, are at risk of declining earnings or even bottom-line losses. Among the financial institutions we rate, that includes captive auto finance companies (those owned by auto manufacturers), given that they hold the lion's share of leases. Because of their loan exposure, it also includes two nonbank auto finance companies, DriveTime Automotive Group and Credit Acceptance, as well as a handful of banks--most notably Santander Holdings U.S.A. (SHUSA) and Ally Financial.

Overview

- S&P Global Ratings believes that the financial institutions that hold significant amounts of retail auto leases and nonprime loans face the greatest risks from potentially lower used-car prices and declining asset quality in auto lending.
- Our ratings on these companies factor in the expectation of some continued deterioration in auto finance asset quality and vehicle prices. However, a sharp rise in loan losses or substantial drop in used-car prices could affect some ratings.
- Captive finance companies hold the greatest amounts of auto leases and would have to report greater depreciation on leases if used-car prices fell.
- The two nonbank auto finance companies we rate, DriveTime and Credit Acceptance, focus on subprime lending and are exposed to the rising losses being reported in that asset class--although our speculative-grade ratings on those companies factor in an expectation of high losses.
- Most banks we rate have limited exposure to auto finance or focus on prime lending. However, banks with large exposures, including SHUSA and Ally Financial, could see notable earnings pressure from declining conditions in the auto finance market.

If used-car prices continue to fall, the captives likely will have to report higher depreciation expenses on their leases, and nonprime lenders will have lower recoveries on defaulted loans. A further increase in delinquencies and losses on loans would affect lenders. We could lower our ratings on companies in auto finance if these trends were severe enough. A few factors that provide some protection against downgrades include support from parents (as in the case of the captives and SHUSA), diversification outside of auto (for most banks), and ratings that already factor in an expectation of high losses on auto loans (as in the case of the nonbank finance companies). Still, we view worsening

conditions in auto finance as a negative rating factor for all of these companies.

The Multiyear Rise In Auto Finance

According to data from the Federal Reserve, outstanding auto loans have steadily risen at a compounded annual growth rate of roughly 8% since the end of 2010 to a record of more than $1.1 trillion at the end of 2016. Leases have risen even faster. Fed data show that leases finance companies (including captive finance companies) hold have roughly tripled since their trough late in 2010, reaching about $226 billion.

As has been frequently reported, the following factors have helped facilitate the growth in auto lending and leasing:

- Low interest rates;
- Increased lending to borrowers considered to have nonprime FICO scores (usually defined as customers with FICO scores below 660 or 680 and sometimes labeled "near-prime," "subprime," or "deep subprime");
- Longer tenors on loans;
- Higher balances and loan-to-value (LTV) ratios on loans at origination; and
- Relatively strong used-car prices over an extended period (which have helped keep lease prices more affordable and allow for better recoveries on loans that default).

We believe many auto finance companies have used risk layering to compete for loans. That is, they have weakened their underwriting standards in multiple ways--perhaps allowing for lower FICO scores, higher LTVs and balances, and longer terms.

A host of data from sources like the Federal Reserve Bank of New York, as well as credit reporting firms Equifax and Experian, illustrate those points (see charts 1 and 2).

Chart 1

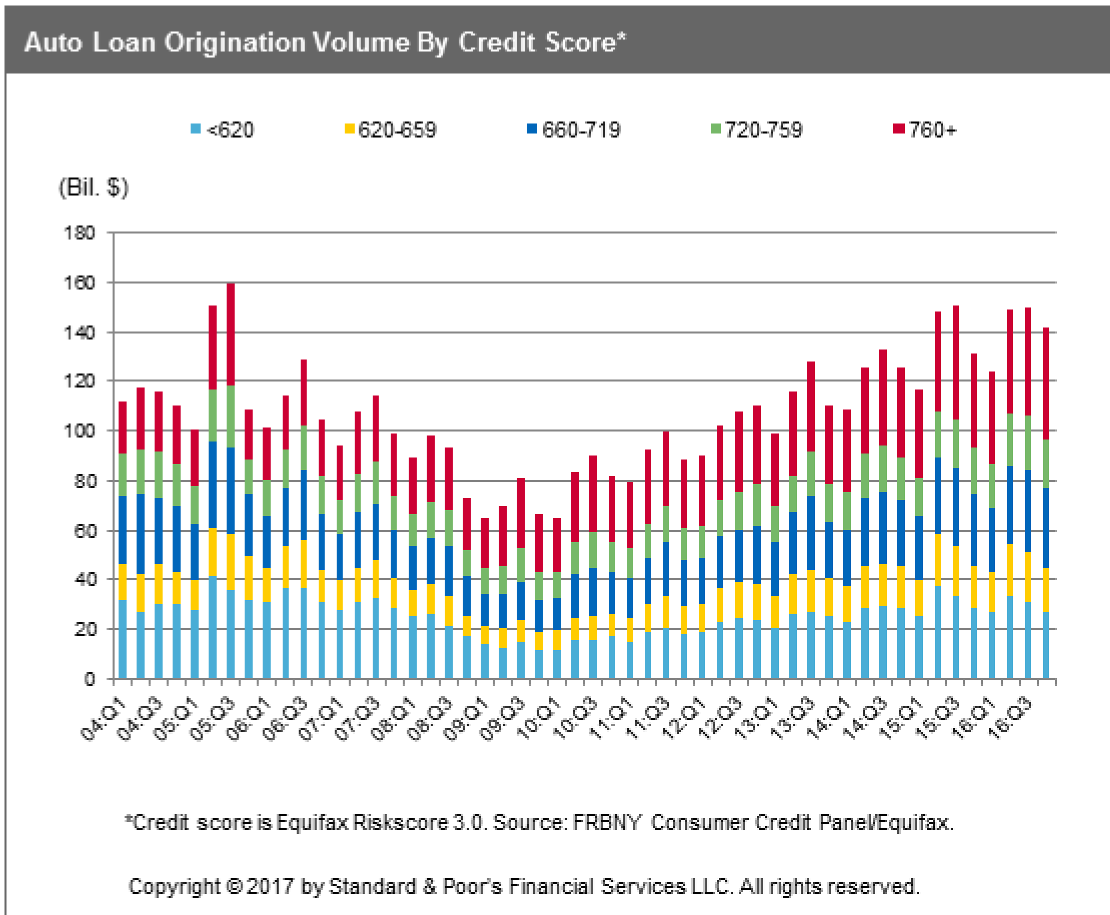
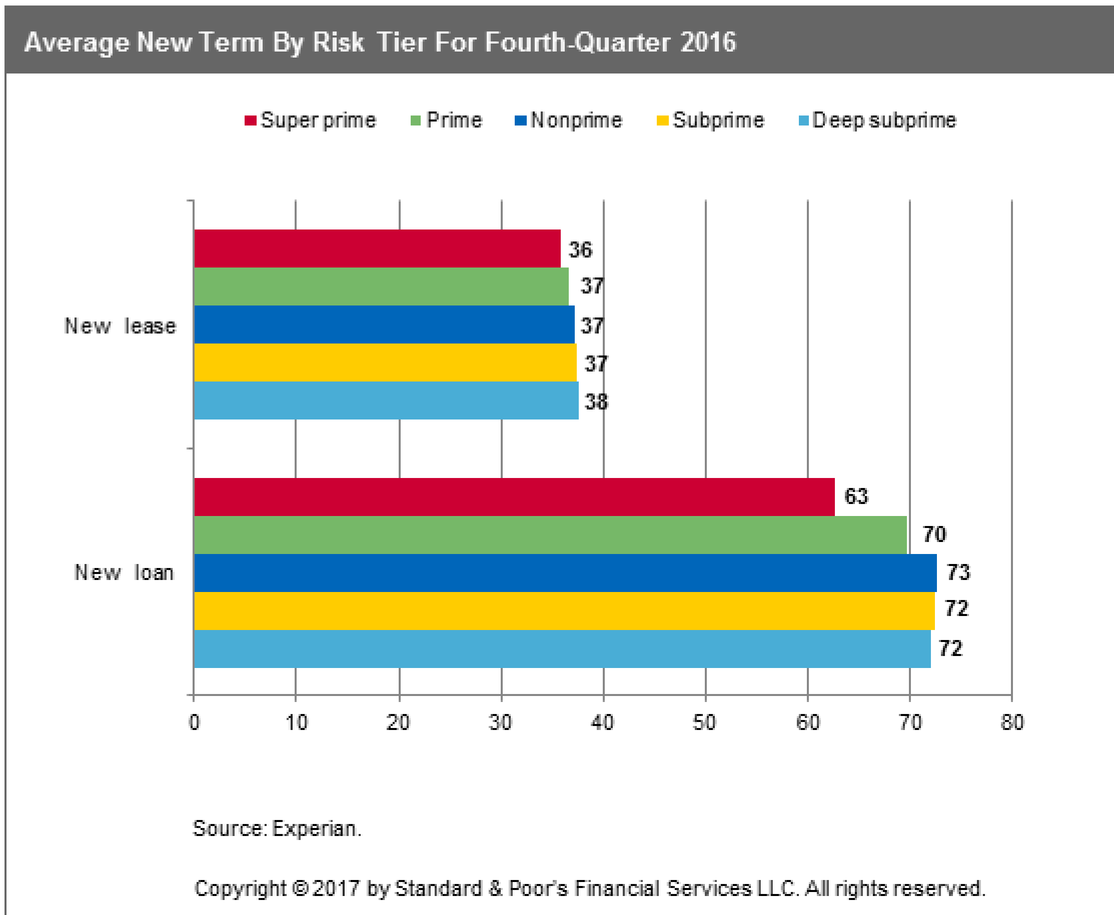


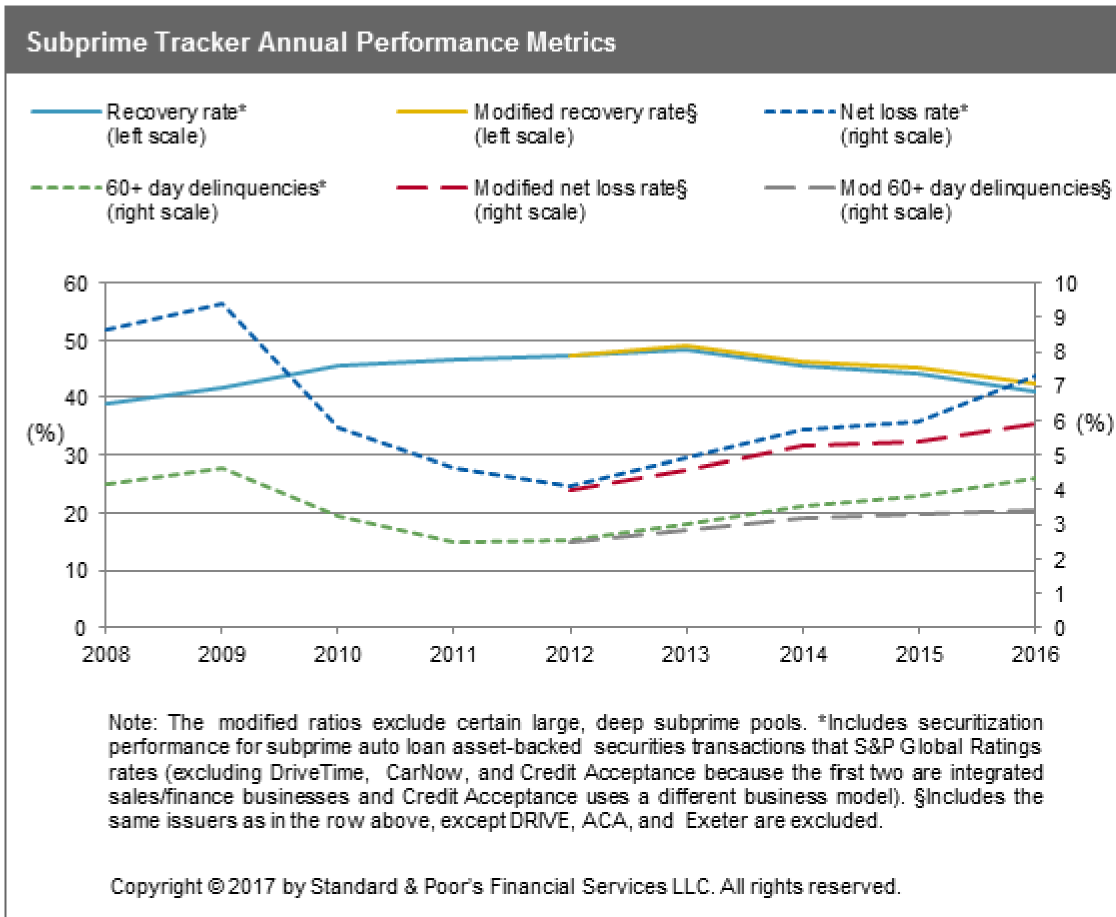
Chart 2



Signs Of Deterioration

Several years now into the auto finance expansion, conditions have been worsening (see chart 3). For instance, losses and delinquencies on subprime loans held in asset-backed securities that we track have risen materially over the last year while recoveries on defaulted loans have fallen (see "U.S. Auto Loan ABS Tracker: March 2017," April 6, 2017).

Chart 3



Note: The modified ratios exclude certain large, deep subprime pools. *Includes securitization performance for subprime auto loan asset-backed securities transactions that S&P Global Ratings rates (excluding DriveTime, CarNow, and Credit Acceptance because the first two are integrated sales/finance businesses and Credit Acceptance uses a different business model). §Includes the same issuers as in the row above, except DRIVE, ACA, and Exeter are excluded.

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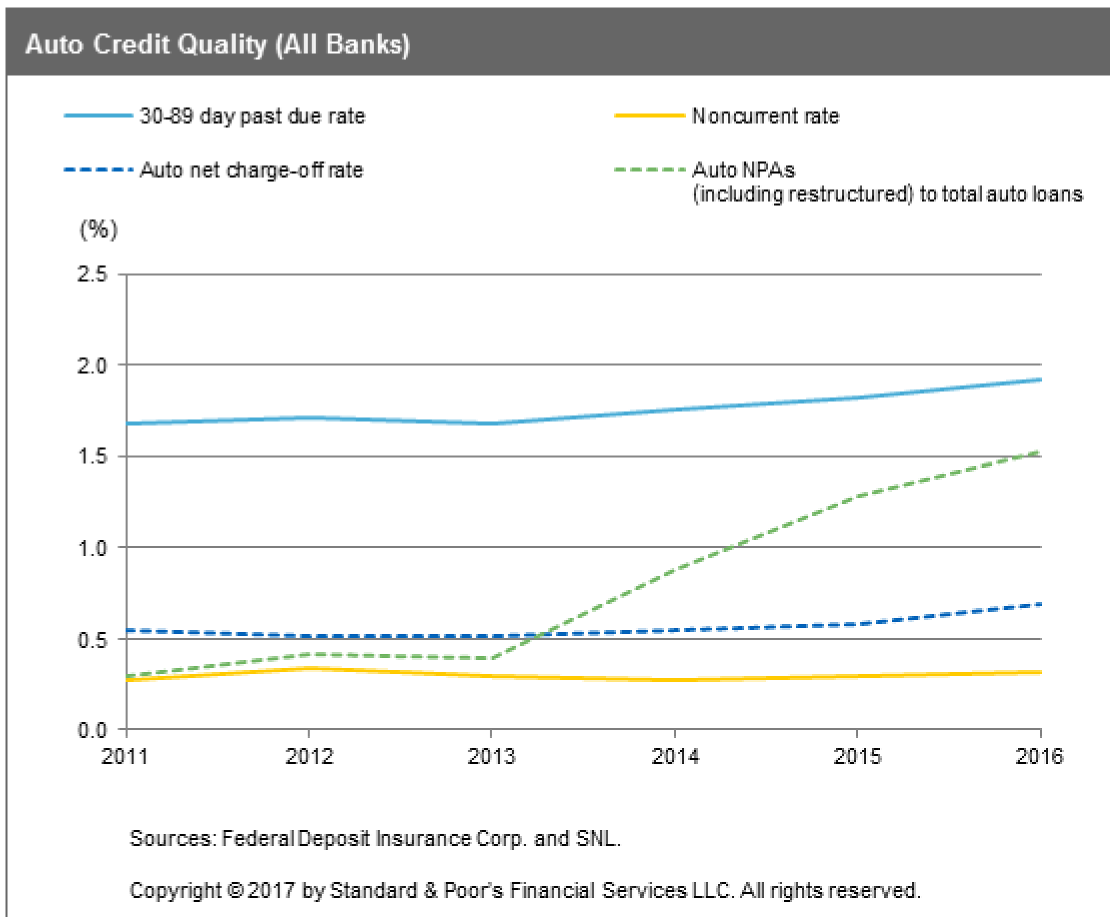
Likewise, auto delinquencies, nonperforming loans, and net charge-offs of auto loans on bank balance sheets have been rising as well (see chart 4). However, net charge-off rates remain at manageable levels of less than 1%.

Chart 4



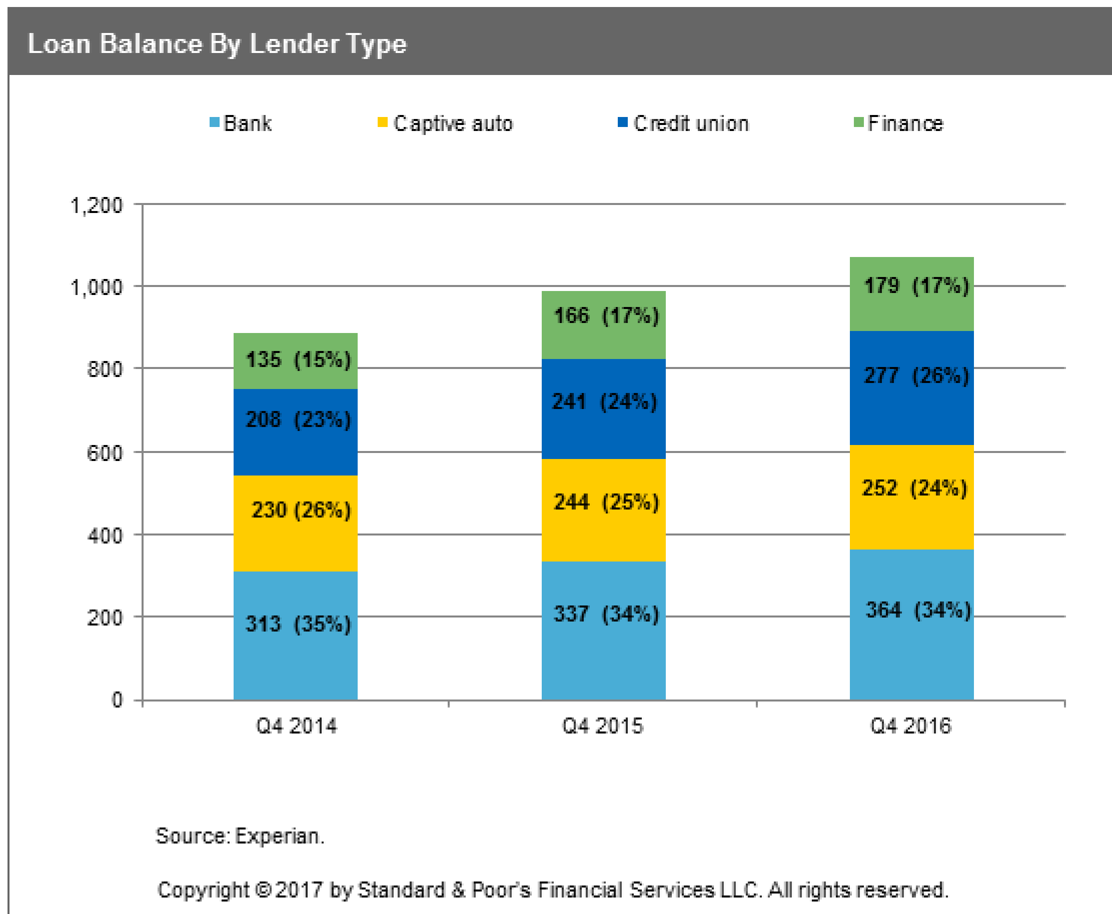
Auto lessors have also been increasing the depreciation they report on leases as some used-car prices have ticked down. The Manheim Used Vehicle Value Index and the National Automotive Dealers Assn. (NADA) used-car price index--two of the best known sources for used-car prices--have both declined for several months to varying degrees. The Manheim Index has fallen modestly since peaking last summer. The NADA index, which uses a different methodology than Manheim and is designed to mimic a fixed pool of vehicles through time, has fallen more significantly, with a notable drop in February.

According to Manheim, vehicles coming off of leases in 2017 will reach a 13-year high this year, up 16% from 2016 (see "U.S. Auto Sales Will Likely Face Headwinds For The Remainder Of 2017 As Demand Continues To Soften," April 6, 2017). Because of that, we have forecasted that the prices for used cars in the leasing portfolios of Ford and GM could fall 5%-7% in 2017, and small/midsize cars and crossover utility vehicles would face the largest declines. We have also said that automakers' inventory levels have risen--though they were not far above the 10-year historical average as measured by days' supply. Manheim has also pointed to high inventories of new vehicles, which could pressure used prices.

Who Has Provided The Financing?

Banks remain the largest retail auto lenders, but captive finance companies, credit unions, and other finance companies have taken market share in recent years. In other words, while banks have steadily grown in auto finance, nonbank competitors have grown even faster. For instance, according to Experian, banks' market share of new financings of auto loans and leases fell to 32.9% in fourth-quarter 2016 from 35.6% a year earlier, while the market shares of the other three sources all edged up. That contributed to a drop in banks' market share of total outstanding auto loans to about 34% at year-end 2016 from more than 35% at year-end 2014 (see chart 5). In fact, credit unions have been adding more auto loans than banks, not only proportionally but on an absolute basis as well. In first-quarter 2017, some banks, including Wells Fargo & Co., indicated that they planned to exercise additional caution in auto lending and perhaps would shrink their originations or portfolios.

Chart 5



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The Risks By Sector

Banks

We believe that most U.S. banks are well-positioned to manage auto finance risks because they tend to have limited amounts of leasing and subprime exposure, or they have little auto exposure in general. We would expect the banks that fit this description to easily absorb any impact from further worsening in auto finance. As a result, we do not expect to lower many bank ratings based on deterioration in auto finance conditions--all else equal--even if that deterioration is severe. Certainly, higher losses on auto loans, even for those that participate in prime auto lending, would be a negative rating factor but probably not one that could cause widespread downgrades on its own.

That said, the handful of banks that participate meaningfully in nonprime lending, most notably SHUSA, or that focus heavily on auto finance, such as Ally, are likely to experience rising auto losses. All else equal, that would lead to lower earnings and potentially bottom-line losses in a severe scenario.

We looked at auto lending reported on regulatory Y-9C reports and added detail from 10-K and 10-Q filings--although the disclosures from those SEC filings vary greatly from bank to bank (see tables 1 and 2). The Y-9C reports provide no information on auto loans beyond their amount, for instance, with no detail on what portion are subprime. Therefore, we reviewed SEC filings to supplement the Y-9C data. But even with that, many banks disclose a limited amount on their auto loans. That is why table 2 contains many spots marked as "not available."

Table 1

Consumer Auto Exposure Of Rated U.S. Banks (Fourth-Quarter 2016)

Displays Only Banks With Retail Auto Loans > 5% Of Total Loans And Leases

					--Retail auto loan growth--	
Company	**Assets (mil. $)**	**Retail auto loans (mil. $)**	**Retail auto loans/loans and leases (%)**	**Retail auto loans/Tier 1 capital (%)**	**One year (%)**	**Three year (%)**
MEDIAN	38,662	32	0.2	1.7	1.3	7.7
MEDIAN - auto loans > 5% of loans	137,367	9,866	8.5	54.3	2.9	21.6
Ally Financial Inc.	163,728	59,109	49.7	390.2	1.7	14.3
Santander Holdings U.S.A. Inc.	137,367	26,466	29.9	157.1	3.8	N.M.
OFG Bancorp	6,502	896	21.0	109.3	(2.9)	(13.4)
Capital One Financial Corp.	357,158	47,916	19.4	144.5	15.3	50.4
Huntington Bancshares Inc.	99,714	10,956	16.2	128.2	15.9	62.7
TCF Financial Corp.	21,455	2,902	16.0	129.1	3.9	120.0
Citizens Financial Group Inc.	150,023	12,930	11.9	91.9	(1.0)	37.9
Fifth Third Bancorp	142,177	9,429	10.2	68.5	(14.5)	(17.2)
FirstBank Puerto Rico	11,907	842	9.4	47.9	(9.3)	(23.9)
First BanCorp	11,922	842	9.4	52.7	(9.3)	(23.9)
BB&T Corp.	219,276	12,357	8.5	58.6	14.0	21.6
Commerce Bancshares Inc.	25,659	973	7.2	41.3	(2.4)	50.0
SunTrust Banks Inc.	205,214	9,866	6.7	54.3	7.8	(5.8)

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Table 1

Consumer Auto Exposure Of Rated U.S. Banks (Fourth-Quarter 2016) (cont.)

Displays Only Banks With Retail Auto Loans > 5% Of Total Loans And Leases

					--Retail auto loan growth--	
Company	**Assets (mil. $)**	**Retail auto loans (mil. $)**	**Retail auto loans/loans and leases (%)**	**Retail auto loans/Tier 1 capital (%)**	**One year (%)**	**Three year (%)**
U.S. Bancorp	445,964	17,571	6.3	44.6	5.9	27.9
Wells Fargo & Co.	1,930,115	62,307	6.3	36.4	3.9	22.6
Valley National Bancorp	22,864	1,086	6.3	64.0	(9.8)	20.5
PNC Financial Services Group Inc.	366,872	12,377	5.8	34.3	11.1	15.6
JPMorgan Chase & Co.	2,490,972	50,271	5.5	24.2	5.6	21.1
BBVA Compass Bancshares Inc.	87,080	3,106	5.2	39.3	(13.8)	43.7
Regions Financial Corp.	126,194	4,068	5.0	33.1	2.9	35.9
BMO Financial Corp.	128,089	3,349	5.0	28.1	(47.2)	(49.8)

N.M.--Not meaningful. Sources: Companies' regulatory filings.

Table 2

Retail Auto Exposure Information From SEC Filings

		--Notes from SEC filings-			
Company	**Retail auto loans/total loans (%)**	**FICO information**	**Term information**	**Yield on auto Loans**	**Auto leases**
Ally Financial Inc.	49.7	688 average FICO for originations in 2016; two lowest tiers had average FICOs of 608 and 642 and accounted for only 26% of loans	Terms have lengthened; of originations in 2016, 15% had a term of 76 months or more, 67% had 72-75 months, and 18% had 71 months or less; in 2014, those ratios were 2%, 72%, and 26%	Yields have risen; "average buy rate"--akin to yield--was 6.35% on retail auto loans purchased through September 2016, up from 5.75% a year earlier	$11.5 billion of leases, about 7% of assets
Santander Holdings U.S.A. Inc.	29.9	Mostly subprime; most borrowers had FICOs below 600 or no FICO at all at year-end 2016	N.A.	18.14% reported on retail installment contracts and auto loans in 2016	$9.7 billion of leases, about 7% of assets
OFG Bancorp	21.0	N.A.	N.A.	11.34% on those obtained in bank acquisitions and 9.65% on other autos loans and leases	N.A.
Capital One Financial Corp.	19.4	31% 620 or below at time of origination; 17% 621-660; 52% greater than 660	N.A.	7.7% average portfolio yield in 2016	N.A.
Huntington Bancshares Inc.	16.2	Predominantly prime; only 12% had FICO below 650 in 2016	N.A.	3.32% portfolio yield for 2016	N.A.
TCF Financial Corp.	16.0	732 average original FICO at Q1 2017	N.A.	4.15% portfolio yield at Q1 2017	N.A.
Citizens Financial Group Inc.	11.9	749 weighted average FICO for 2016 originations	N.A.	2.94% portfolio yield for 2016	N.A.

Table 2

Retail Auto Exposure Information From SEC Filings (cont.)

		--Notes from SEC filings-			
Company	**Retail auto loans/total loans (%)**	**FICO information**	**Term information**	**Yield on auto Loans**	**Auto leases**
Fifth Third Bancorp	10.2	83% of outstanding auto loans had a FICO >690 in 2016	N.A.	2.71% portfolio yield for 2016	N.A.
FirstBank Puerto Rico	9.4	N.A.	N.A.	N.A.	N.A.
First BanCorp	9.4	N.A.	N.A.	N.A.	N.A.
BB&T Corp.	8.5	N.A.	N.A.	N.A.	N.A.
Commerce Bancshares Inc.	7.2	743 weighted average FICO in 2016	N.A.	N.A.	N.A.
SunTrust Banks Inc.	6.7	23% of indirect consumer loans (likely mostly auto) had FICOs of 620-699 and 7% had FICOs <620	N.A.	N.A.	N.A.
U.S. Bancorp	6.3	N.A.	N.A.	N.A.	N.A.
Wells Fargo & Co.	6.3	16% had FICO <600 and 27% had FICO of 600-679 in 2016	N.A.	N.A.	N.A.
Valley National Bancorp	6.3	N.A.	N.A.	N.A.	N.A.
PNC Financial Services Group Inc.	5.8	Average FICO of 760 on indirect auto originations in 2016	N.A.	N.A.	N.A.
JPMorgan Chase & Co.	5.5	Average FICO of 754 on 2016 originations	Average term of 65 months on 2016 originations	N.A.	$11 billion of average auto operating leases at Q4 2016, less than 1% of assets
BBVA Compass Bancshares Inc.	5.2	N.A.	N.A.	N.A.	N.A.
Regions Financial Corp.	5.0	11% of originations to borrowers with FICO <620; 13% with FICO of 620-680 on indirect auto	N.A.	N.A.	N.A.
BMO Financial Corp.	5.0	N.A.	N.A.	N.A.	N.A.

N.A.--Not available.

SHUSA may be the largest subprime auto lender in the country--via its majority ownership in Santander Consumer U.S.A. (SCUSA). Auto loans made up about 30% of SHUSA's loans at year-end 2016, and the majority of its borrowers had FICO scores below 600 or no FICOs at all. The 18% yield on its auto loans also underscores the high risk of those loans. For SHUSA, worsening conditions could not only pressure earnings but also lead to bottom-line losses. We could lower our stand-alone credit profile (SACP) (our view of an entity's strength on a stand-alone basis) of SHUSA if delinquencies and losses in its auto portfolio rise materially. However, we consider SHUSA a highly strategic subsidiary of Santander that would receive support from the parent if needed.

Ally Financial competes minimally in "deep" subprime auto, but it has the largest concentration in auto in general

among banks we rate and material holdings of loans considered less-than-prime. Retail auto loans made up almost half of its loans and leases, and, though they have declined, leases accounted for 7% of assets. Its average FICO on retail auto originations was 688 at year-end, with 24% of retail and lease originations having FICO scores of 740 or higher, 36% having FICO scores of 660-739, and 24% having FICO scores of 620-659. In October 2016, we revised our outlook on Ally Financial to stable from positive in anticipation of potentially higher losses on auto loans, and we currently expect some worsening in its retail auto loan portfolio. However, if losses rise especially sharply, we could consider lowering the rating.

Capital One Financial is another bank that competes meaningfully for nonprime customers and likely competes more than Ally for deep subprime. Almost one-third of its auto loans had a FICO below 620 at origination at year-end 2016. Deterioration in auto finance would be a negative rating factor for Capital One. Still, barring outsize problems in auto, it is unlikely we would lower the rating based on that deterioration alone given the company's diversification outside of auto finance.

A handful of other banks also participate to a degree in nonprime and subprime auto lending. Wells Fargo, for instance, reported that many of its auto borrowers were nonprime, though retail auto loans made up only 6% of loans at year-end 2016. However, Wells Fargo said after first-quarter 2017 that it was pulling back in auto. Some of the banks in Puerto Rico, an area in a significant economic downturn, also have fairly significant auto exposure, including OFG Bancorp. We believe OFG's auto loans are almost all to borrowers in Puerto Rico, and our speculative-grade rating on OFG reflects the high risk of its loans in general.

We believe most banks, however, either have low amounts of auto loans and leases or focus on prime lending. For instance, auto made up 16% of the loans of Huntington Bancshares, but a small percentage of those loans had a FICO below 650 in 2016. We also believe that Citizens Financial Group, Fifth Third Bancorp, Commerce Bancshares, and U.S. Bancorp, all of which had meaningful auto exposure, focus largely on prime lending.

Gauging loss potential on bank auto loans. We estimated the potential for earnings pressure, or even bottom-line losses and capital depletion, from rising losses on auto loans (see table 3). To do this, we assume:

- A given bank's net charge-offs of auto loans will rise by either 20%, 50%, or 100% from 2016 levels; and
- The bank's provision will increase by an amount equal to the rise in its charge-offs.

For instance, if a bank's auto net-charge offs equated to 1% of loans in 2016, we assume those net charge-offs will rise to 1.2%, 1.5%, or 2.0%, and that the bank will provision an incremental amount equal to 20 basis points (bps), 50 bps, or 100 bps of average auto loans (with the assumption that it provisioned the same level as it charged off in 2016).

We also looked at how significantly those assumptions would affect a bank's return on average assets (ROAA) (see table 3). For instance, if the auto net charge-offs of Huntington Bancshares doubled in 2017 from the 0.35% it reported in 2016 (to 0.70%), its ROAA would be only 5 bps lower than otherwise under these assumptions. (Huntington had almost $11 billion of auto loans at year-end 2016. An additional provision equal to 35 bps of average auto loans is less than $40 million, and the company had average assets about $83 billion.)

For the majority of banks, the impact on ROAA is quite manageable. However, it is meaningful for some--SHUSA, in particular. Its net charge-offs were more than 8% of average auto loans in 2016. If that doubled, its ROAA would be

159 bps lower under these assumptions--easily high enough to wipe out the 45 bps of ROAA it reported in 2016.

A doubling of net charge-offs would also materially eat into Ally's profitability but would not necessarily cause a bottom-line loss under these assumptions. That would be at least partially offset by the higher yields on new originations, reflecting the shift in its composition of originations. Banks like OFG, Capital One, and TCF Financial would also see some earnings pressure, but not enough to cause bottom-line losses.

Table 3

Consumer Auto Exposure Of Rated U.S. Banks (Fourth-Quarter 2016)

Displays Only Banks With Retail Auto Loans > 5% Of Total Loans And Leases

			--Auto NCOs/average loans--		--Auto 30-89 days past due--		--Estimated impact to ROAA if auto net charge-offs rise by--			
Company	**Assets (mil. $)**	**Auto loans (mil. $)**	**2016 (%)**	**Year-over-year change (%)**	**Q4 2016 (%)**	**Year-over-year change (%)**	**20%**	**50%**	**100%**	**2016 ROAA (%)**
MEDIAN	38,662	32	0.24	0.11	0.85	0.06	(0.00)	(0.00)	(0.00)	0.87
MEDIAN - auto loans > 5% of loans	137,367	9,866	0.79	0.13	1.57	0.15	(0.01)	(0.02)	(0.05)	0.93
Ally Financial Inc.	163,728	59,109	1.34	0.34	3.56	0.42	(0.10)	(0.25)	(0.50)	0.68
Santander Holdings U.S.A. Inc.	137,367	26,466	8.08	1.35	11.08	0.90	(0.32)	(0.80)	(1.59)	0.45
OFG Bancorp	6,502	896	2.09	(0.27)	9.43	(3.48)	(0.06)	(0.14)	(0.28)	0.88
Capital One Financial Corp.	357,158	47,916	1.69	0.00	6.12	(0.58)	(0.05)	(0.12)	(0.24)	1.10
Huntington Bancshares Inc.	99,714	10,956	0.35	0.12	0.85	(0.04)	(0.01)	(0.02)	(0.05)	0.86
TCF Financial Corp.	21,455	2,902	1.15	0.30	0.59	0.08	(0.03)	(0.08)	(0.16)	1.01
Citizens Financial Group Inc.	150,023	12,930	0.71	0.19	1.57	0.39	(0.01)	(0.03)	(0.06)	0.73
Fifth Third Bancorp	142,177	9,429	0.34	0.14	0.86	0.22	(0.00)	(0.01)	(0.02)	1.11
FirstBank Puerto Rico	11,907	842	1.71	(0.45)	8.39	(1.05)	(0.02)	(0.06)	(0.12)	0.78
First BanCorp	11,922	842	1.70	(0.45)	8.39	(1.05)	(0.02)	(0.06)	(0.12)	0.75
BB&T Corp.	219,276	12,357	2.47	0.45	2.75	(0.19)	(0.03)	(0.07)	(0.14)	1.11
Commerce Bancshares Inc.	25,659	973	0.72	0.18	1.32	0.32	(0.01)	(0.01)	(0.03)	1.13
SunTrust Banks Inc.	205,214	9,866	0.61	0.17	1.18	0.15	(0.01)	(0.02)	(0.03)	0.95
U.S. Bancorp	445,964	17,571	0.36	0.13	0.72	0.22	(0.00)	(0.01)	(0.01)	1.36
Wells Fargo & Co.	1,930,115	62,307	0.84	0.12	2.51	0.25	(0.01)	(0.01)	(0.03)	1.17

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Table 3

Consumer Auto Exposure Of Rated U.S. Banks (Fourth-Quarter 2016) (cont.)

Displays Only Banks With Retail Auto Loans > 5% Of Total Loans And Leases

			--Auto NCOs/average loans--		--Auto 30-89 days past due--		--Estimated impact to ROAA if auto net charge-offs rise by--			
Company	**Assets (mil. $)**	**Auto loans (mil. $)**	**2016 (%)**	**Year-over-year change (%)**	**Q4 2016 (%)**	**Year-over-year change (%)**	**20%**	**50%**	**100%**	**2016 ROAA (%)**
Valley National Bancorp	22,864	1,086	0.14	0.05	0.36	0.16	(0.00)	(0.00)	(0.01)	0.76
PNC Financial Services Group Inc.	366,872	12,377	0.44	0.14	0.51	0.05	(0.00)	(0.01)	(0.02)	1.08
JPMorgan Chase & Co.	2,490,972	50,271	0.57	0.09	1.33	(0.05)	(0.00)	(0.01)	(0.01)	1.01
BBVA Compass Bancshares Inc.	87,080	3,106	1.86	0.71	3.51	0.98	(0.01)	(0.03)	(0.06)	0.41
Regions Financial Corp.	126,194	4,068	0.79	0.12	1.70	0.14	(0.01)	(0.01)	(0.03)	0.93
BMO Financial Corp.	128,089	3,349	0.24	0.13	1.15	0.51	(0.00)	(0.00)	(0.01)	0.51

NCOs--Net charge-offs. ROAA--Return on average assets. Source: Companies' regulatory filings.

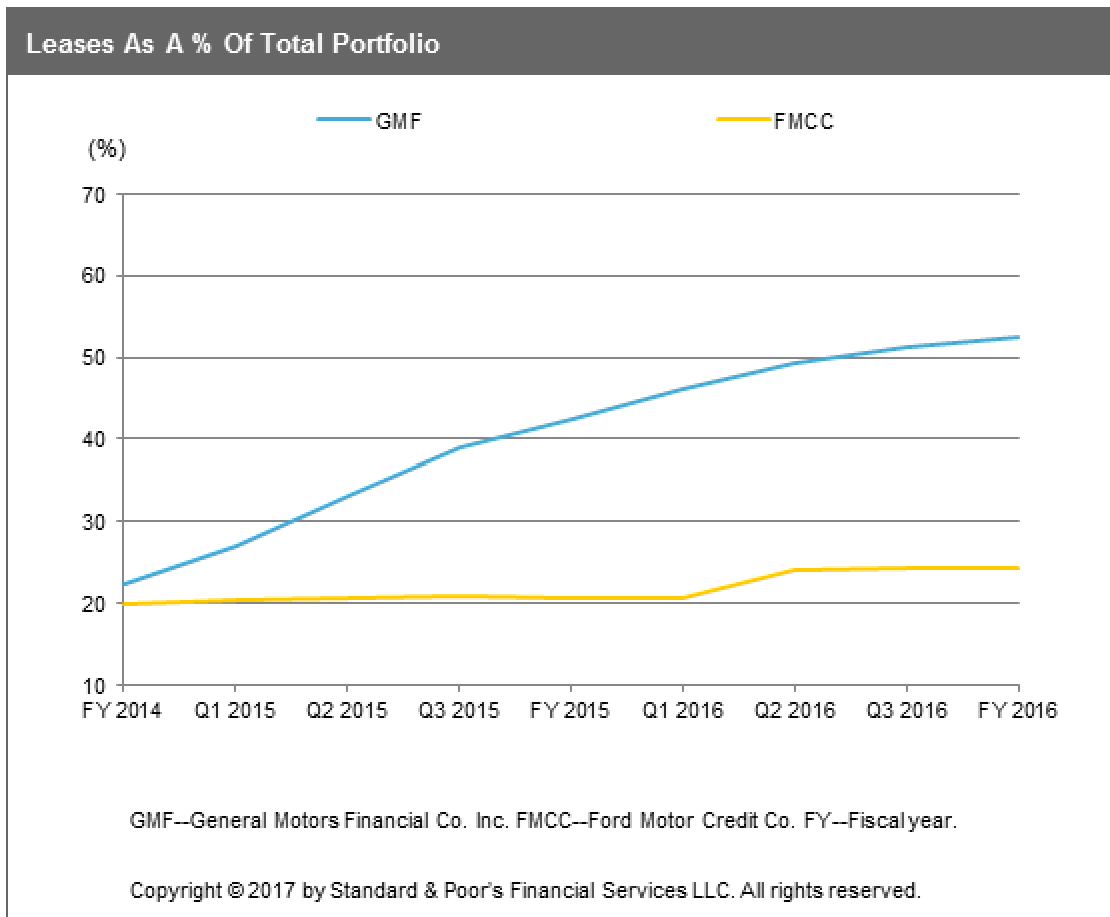
Captive finance companies

We believe the captive auto finance companies we rate generally have the greatest exposure to leases. Post the financial crisis, the percentage of new vehicles registered that are leased for these companies has risen materially, particularly at Ford, GM, and Chrysler.

According to Experian automotive, leasing accounted for more than 31% of new car transactions in the first half of 2016. Car shopping website Edmunds reported 2.2 million vehicles were leased in the first half of 2016, double the volume of the same period in 2011 and up 13% from the first half of 2015. It also said the number of vehicles coming off lease will rise to 4 million in 2018 from 2.6 million in 2015. That could put pressure on used-car prices.

Here we discuss General Motors Financial Co. Inc. (GMF) and Ford Motor Credit Co. (FMCC), although similar trends apply to other captives as well. GMF's lease receivables increased to 52% of its total gross receivables in 2016 from 22% in 2014 (see chart 6), largely as a result of a subvention leasing program with its parent. Under the subvention programs, GM makes cash payments to GMF for offering incentivized rates and structures on its finance products. FMCC's lease portfolio increased to 24% in 2016 from 20% in 2014.

Chart 6



Such leases expose these companies to the risk that used-car prices will decline further, forcing them to take larger-than-expected deprecation on leased automobiles. At a minimum, that will eat into their profitability. We have seen Ford and General Motors reducing sales to rental car fleets to lessen the impact on residual values.

When these companies originate leases, they book them as operating leases and estimate what the residual value of the vehicle will be at the end of the lease. They base the required lease payments from the customer on the difference between the value of the vehicle at the time of origination and the estimated residual value with a yield built in. They then report the customer's payment as lease income, and they depreciate the vehicle over the life of the lease to the residual value.

During the life of the lease, the lessor may lower its estimate of the residual value of the lease, forcing it to report additional depreciation, thereby reducing the profitability of the lease. At the end of the lease, it may also sell the vehicle, perhaps reporting further losses if the sale price falls short of the then estimated residual value.

Several lessors, such as FMCC, have been reporting increased depreciation on leases, reducing profitability from what it otherwise would be. At year-end 2016, FMCC showed that a hypothetical 1% decline in the auction values on its Ford and Lincoln brand vehicles would force it to report $120 million more in additional depreciation. In fact, in

first-quarter 2017, FMCC's pretax profit declined by $33 million to $481 million as lower auction values led to an increase in supplemental depreciation. The company gave guidance for 2017 profit before tax of $1.5 billion, compared with the $1.9 billion in pretax income it reported in 2016, which includes the potential impact of lower residual values, higher credit losses, and rising interest rates.

At year-end 2016, GMF showed that its estimated residual value of its leased vehicles was $23.6 billion in fourth-quarter 2016 and that a 1% decline in those values would cause a $236 increase in depreciation. As of first-quarter 2017, GMF had lower residual values, especially in crossover segments, and expects used-car prices to decline by 7% in 2017 compared with 2016. However, even with that, the company expects its pretax income to rise sharply on the back of continued expansion.

The captive finance companies are a unique example because our ratings on them are the same as the ratings on their auto manufacturing parents based on our view that their parents would provide support if needed. Therefore, some weakening at the captives would not necessarily cause us to lower ratings on both the captives themselves and their parents. Still, weakened creditworthiness at a captive would certainly be a negative rating factor for its parent and, if large enough, could contribute to lower ratings on both the captive and parent.

We believe GMF's large amount of leases as a portion of receivables, as well as its book of subprime auto loans, exposes it to lower used-car prices as well as credit risk on its loans. (Subprime loans as a percentage of its total loans has been dropping, but loans to borrowers with a FICO of less than 620 at origination still accounted for 43% of its loans at the end of first-quarter 2017.) FMCC has less subprime and a lower proportion of its receivables in leases. Still, lower used-car prices could pressure its earnings.

Nonbank lenders

The nonbank auto finance companies we rate--DriveTime and Credit Acceptance--face the risk that more borrowers will default on their subprime auto loans and that a drop in used-car prices will weigh on recoveries. Because, even in normal times, subprime auto loans default at high rates, the recovery is crucial in determining profitability. A rise in both defaults and loss given default (or a drop in recoveries) can be very detrimental. The inherent volatility, credit risk, and funding risk in subprime auto lending limit our ratings on both DriveTime and Credit Acceptance. An assumption that losses will typically be high in this industry and earnings can suffer limits our ratings on DriveTime and Credit Acceptance to 'B' and 'BB', respectively. For that reason, we don't necessarily expect to lower ratings simply because losses rise, and we have stable outlooks on both ratings. That said, in the event that losses rise especially high or there are other adverse changes beyond our expectations, the ratings could come under pressure.

In recent years, competition intensified for subprime auto lending, likely causing underwriting standards in the industry to weaken. Increased competition means loan growth is more difficult to achieve without targeting new markets, increasing loan terms and loan balances, or weakening underwriting in other ways. For instance, originations for 2016 across lenders saw higher average loan sizes, longer terms, higher APRs (annual percentage rates), and smaller down payments compared with five years ago. DriveTime reported a 105 bps increase in APR relative to 2011, average term increased seven months to 53 months, loan size increased 16%, and down payment decreased 200 bps relative to the loan size. Credit Acceptance also lengthened terms and took other steps to support origination volumes.

Positively, neither DriveTime nor Credit Acceptance has a material amount of leases. Still, used-car prices are a crucial

determinant of recoveries given that a substantial portion of their loans default in all parts of the credit cycle. DriveTime reported an 8% decline in auction proceeds, as a percent of base cost for 2016, and expects another 5%-7% decline in 2017. It, like other buy-here/pay-here companies, benefits to an extent from lower used-car prices because it not only makes loans, but it also sells cars from its lots. It can purchase vehicles more inexpensively when prices drop. However, in many cases, buy-here/pay-here dealers tend to pass along any savings in purchase costs to the customers and churn their inventory quickly enough to minimize inventory write-downs. Therefore, we expect buy-here/pay-here companies to experience similar losses from disposal of repossessed cars as pure lenders.

In addition, some industry participants believe that falling used-car prices can lead to higher defaults (not just lower recoveries). Credit Acceptance estimates that falling used-car prices and the associated increased depreciation will decrease collections on its loans by 300 bps relative to when depreciation estimates were at their lowest. Increased depreciation will put more of the company's customers further under water on their loans than they would otherwise be. Lower used-car prices also may encourage them to default on one loan with the hope of purchasing a better car at a lower price with lower payments. We believe it is not uncommon for a borrower with a subprime loan to default on that loan only to purchase and finance another vehicle from another lender.

Improving Economic And Employment Conditions Could Benefit Auto Finance, But Loan Losses Are Likely To Continue Rising

Recently, there have been signs that certain lenders, concerned that industry underwriting standards have eased too much, have reduced their appetite for auto loans. Such a change should reduce the odds of a major increase in auto loan losses and sharply reduced used-car prices. A strong economy and employment conditions would also help auto finance by helping to reduce delinquencies and probably by supporting used-car prices.

Still, after years of robust growth and loosened underwriting, a continued rise in loan losses and a drop in used-car prices seem likely. The questions are how far will used prices fall--especially for the captives--and how substantially will delinquencies rise--especially for nonbank auto lenders as well as a handful of banks.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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