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Financial Services Practice

Disruption and innovation in US auto financing

The relatively stable auto financing market appears poised for change as strong demand draws the attention of a broad range of attackers.

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Dramatic changes have marked the US financial services industry over the last five to seven years. In the mortgage market, low-cost digital attackers have been gaining significant share, and retail payments have seen the emergence of buy-now, pay-later players. Auto financing, by contrast, has experienced relatively little disruption over the past decade.

This period of relative stability may be about to end. In the last 18 months, the industry has seen a sharp increase in demand. A diverse and expanding set of lenders—large banks, regional banks, online retailers, and fintechs—are considering moves into this asset class.

Incumbents in the auto financing segment will continue to play a key role if they prepare for disruption. They should consider taking advantage of market tailwinds to increase origination and evaluating initiatives to improve profitability and establish greater dealer stickiness. Also, in the current uncertain economic environment, they will need to heighten their focus on delinquency rates.

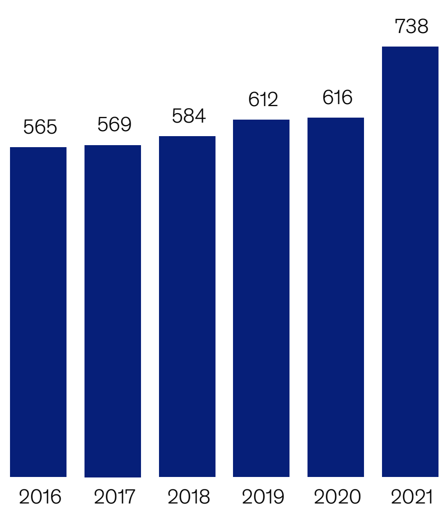
Robust demand but disruption in store

US auto loan origination grew just 2 percent a year from 2016 to 2020, with indirect financing through dealership networks accounting for around three-quarters of total consumer financing volume. In 2021, demand spiked 20 percent, accompanied by a corresponding increase in used-vehicle prices (Exhibit 1). Meanwhile, high interest rates and limited housing inventory are presenting challenges to growth in other consumer asset classes, such as mortgages and unsecured lending.

Exhibit 1

US auto loan originations increased sharply in 2021, as prices rose in response to demand growth and supply shortages.

Value of automotive loans originated in the US, 2016–21, $ billion



Source: Big Wheels Auto Finance Data; Edmunds; *Experian State of the Automotive Finance Market Report*; New York Federal Reserve

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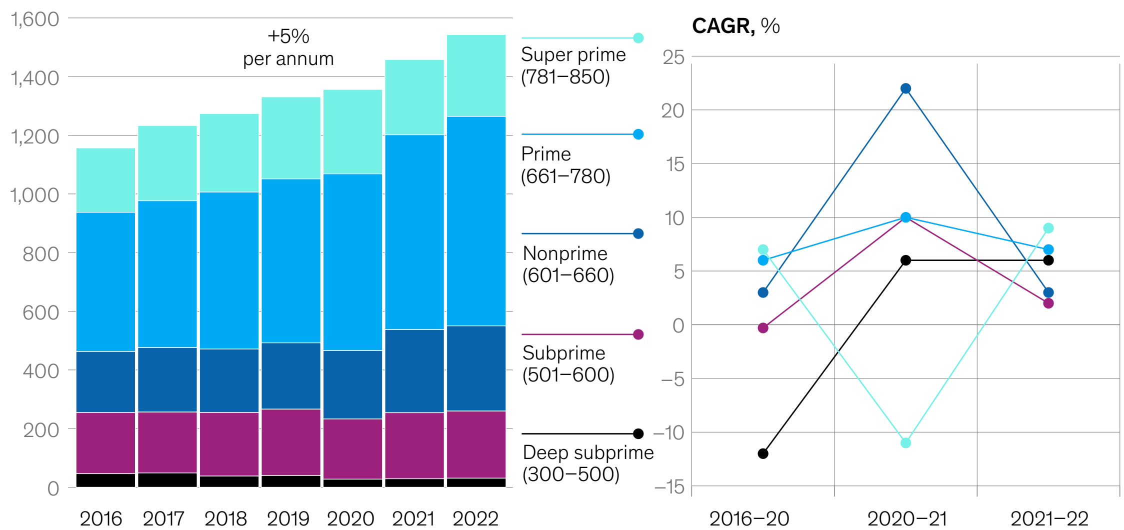
Other factors are making auto financing more attractive. The used-car prime segment, for example, has become more addressable thanks to a combination of two factors: an increase in the consumer price index for used cars and trucks of 40 percent between January 2021 and July 2022 (due to supply shortages); and the ongoing upward credit migration of customers (Exhibit 2)—driven by continued economic expansion and by a gradual increase in sophistication across underwriting, fraud detection, and collection processes. Rental-car companies' average fleet sizes also have played a role. In 2020, when pandemic-related shutdowns halted business and personal travel, several rental companies faced the threat of bankruptcy and were forced to liquidate their fleets. Then 2021's relaxed travel restrictions led to a spike in rental-car demand and shortages of new-vehicle inventory, forcing companies to turn to used vehicles to replenish their fleets.

The auto financing industry has been evolving as various players seize the opportunities. Captive lenders won greater market share in 2020. In 2021, incumbent banks pushed back by relaxing credit restrictions, regaining the territory they'd lost (Exhibit 3). More recently, as interest rates increased in 2022, credit unions marginally overtook banks in market share (28 percent of financing compared with 27 percent for banks),[1] due in part to lower pricing.[2]

Exhibit 2

There has been a gradual upward credit migration among US auto finance consumers.

US outstanding car loans by credit score,[1] $ billion



[1]Estimate for 2021 loans based on 2022 Q3 YTD actual data and 2022 Q4 extrapolation based on historical quarter-to-quarter growth rate.
Source: Big Wheels Auto Finance Data; *Experian State of the Automotive Finance Market Report*; New York Federal Reserve

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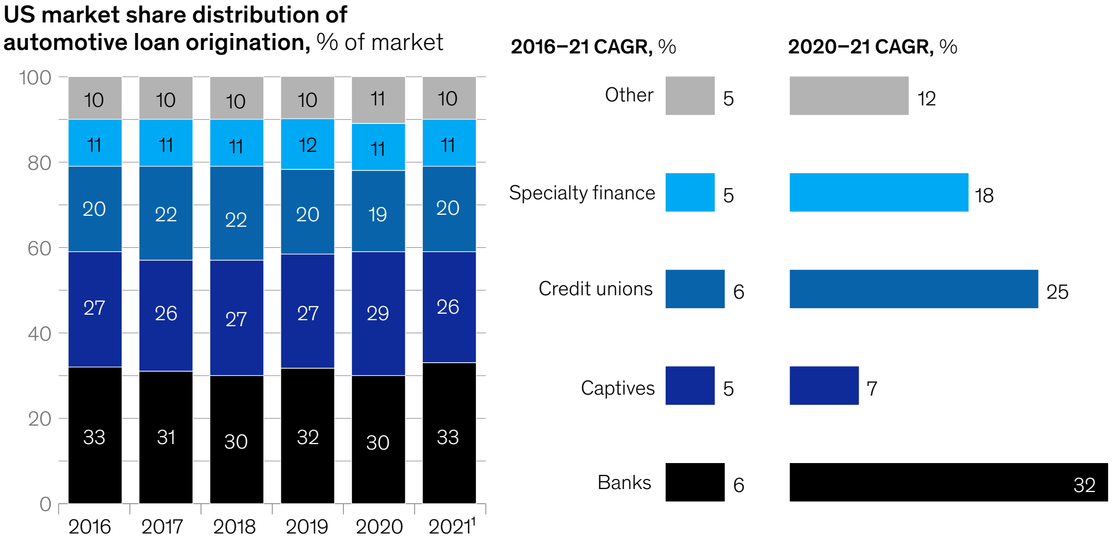
[1] Melinda Zabritski, "Used vehicles and SUVs remain prominent in Q3 2022," Experian, December 6, 2022.
[2] Ben Eisen, "Auto-loan interest rates are skyrocketing. No one told credit unions," *Wall Street Journal*, December 27, 2022.

Exhibit 3

Banks regained auto finance share in 2021.



[1]Estimate for 2021 based on Q3 2020 actual data and Q4 2020 extrapolation based on historical quarter-to-quarter growth rate.
Source: Big Wheels Auto Finance Data; *Experian State of the Automotive Finance Market Report;* New York Federal Reserve

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The value chain for auto purchase and ownership has transformed over the past few years, opening up new opportunities for financial services. Regional banks, online auto retailers (for example, Carvana and Vroom), and a number of fintechs (including AutoFi, AUTOPAY, and Caribou Financial) are entering or have recently entered the space.

The rise in consumer demand is not the only attraction for lenders with portfolios of consumer asset classes. Particularly in the face of a potential recession, lenders may appreciate auto financing's consistently low delinquencies (less than 3.5 percent) over the past two decades, including during the subprime debt crisis (Exhibit 4). Delinquencies have remained near all-time lows despite lingering unemployment, rising vehicle prices, and relatively higher inflation, in part because borrowers have leaned on financial-hardship programs that let them postpone loan payments. (Despite these conditions, the cushions that have protected this asset class may have begun to diminish.) Another draw for lenders is the average loan length of the asset class—roughly six years according to recent research, which is significantly shorter than the average mortgage.[3] This shorter loan period offers protection against interest rate risk, which has increased with inflation.

New developments in US auto finance

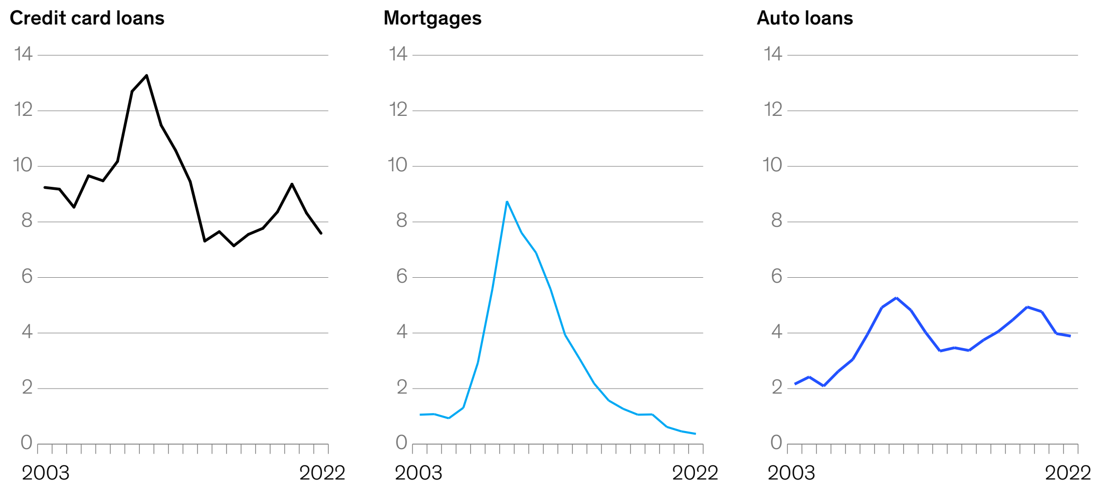
Consumer financing of vehicles typically involves indirect financing through dealership networks,

[3] Warren Clarke, "What's the average car loan length?," Credit Karma, March 2, 2022.

Exhibit 4

Delinquencies have been more stable in US auto financing than in other lending products.

Loans and accounts at least 90 days delinquent by type, % of total



Source: New York Federal Reserve

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which accounts for 70 to 80 percent of total volume. Captive lenders and banks distribute multiple financing and insurance products to dealerships. Their products include consumer auto finance, warranty and payment-protection products (including white-labeled offers), and floor plan and commercial financing programs.[4] Historically, some captive financing units and banks have taken a very siloed approach to distributing these products.

Now more lenders appear to be taking an integrated view of dealer coverage across the full suite of dealer offerings, supported by a comprehensive dealer-level scorecard. Amid rising interest rates, some aim to strengthen their relationships with dealers by taking a holistic approach to pricing that considers multiple components—for example, product pricing rates and fees, dealer compensation, existing programs, and their dealer rewards program. However, we have seen few examples of lenders that have fully succeeded with the approach of charging a premium in their pricing based on holistic dealer offering (Exhibit 5).

Meanwhile, auto retailers are more often making financing a core part of their go-to-market strategy. Asbury Automotive[5] and AutoNation,[6] for example, are exploring launching their own captive financing

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[4] Floor plan financing is a plan in which dealers that finance their inventory through their automobile company receive cash rewards.
[5] Amanda Harris, "Asbury Automotive considers captive finance business launch," *Auto Finance News*, August 30, 2021.
[6] John Huetter, "AutoNation CEO Mike Manley: 'Important' to have captive lender," *Automotive News*, February 21, 2022.

Exhibit 5

Pricing archetypes vary in the US auto financing industry.

Auto financing archetypes

	Formulaic	Competition based	Value centric	Premium
Description	Cost based; margin impact stemming from externalities (eg, rate increases, inflation) typically passed on to end customers	Aspires to strike a balance between increasing margins competitively and losing market share; has a broad spectrum of approaches (eg, price leader or follower) based on competitive dynamics	Maximizes value creation for the end customer/distributor; holds back or delays passing on price increases	Premium pricing for differentiated products/services
Illustrative conditions	Used in select or niche segments (eg, super prime only) where lenders are margin conscious vs pursuing market share Common among banks where auto financing is a smaller part of the consumer book or FTPs are higher	Used in select or niche segments (eg, super prime only) where lenders are margin conscious vs pursuing market share Common among banks where auto financing is a smaller part of the consumer book or FTPs are higher	Focuses on gaining or retaining market share Successful players have some strategic advantage (eg, lower cost of funds, lower operating costs, competitive full-spectrum presence)	Uncommon in auto financing, but some captives could charge a premium based on holistic dealer offering

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units, and Carvana's financing arm has been its only bright spot amid debt-funding struggles.[7] By offering loans, dealership networks can ensure consistent financing across their businesses.

To remain competitive, banks, captives, and other lenders are increasing their use of digital and analytics capabilities. For example, Capital One developed the Auto Navigator tool, which lets car shoppers search for cars and prequalify for financing without affecting their credit scores.[8] AutoFi, which provides digital retail systems to car dealers, banks, OEMs, and online marketplaces, offers a cloud-based pricing platform called Real Payments that lets consumers prequalify for financing and see prices and monthly payments across vehicles within seconds. Further, General Motors has launched its own used-car online retailer, CarBravo, to compete with Vroom, and other online dealers.

Refinancing is increasing, led by fintechs. Fintech players are using partnerships to consolidate as much of the auto refinancing market as they can. Upstart, for instance, uses its own auto lending performance data to power its auto refinancing model.

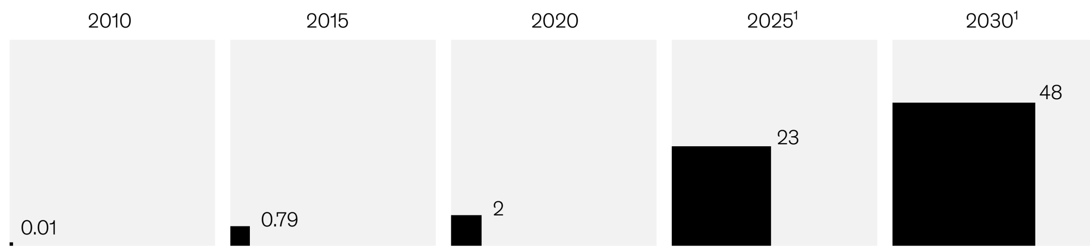
Another growth area will be loans to purchase electric vehicles (EVs), given that their share of car sales is growing at around 70 percent annually (Exhibit 6). Banks have dominated lending in the EV space so far, using indirect lending through dealers. We expect that captives will catch up soon with direct-to-consumer lending, as original equipment

[7] Eliza Ronalds-Hannon and Davide Scigliuzzo, "Carvana edges toward reworking debt as cash burn ups risks," Bloomberg, December 7, 2022.
[8] "Important disclosures and requirements," Auto Navigator, Capital One.

Exhibit 6

Demand for electric vehicles has been growing rapidly, with share of new sales projected to approach 50 percent by 2030.

Total electric vehicle sales in the US, % share of total



[1]Based on McKinsey projections.
Source: McKinsey Center for Future Mobility; McKinsey Electrification Model

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manufacturers transition to using direct-to-consumer EV distribution models.

What auto financing lenders should do now

Competitors in the auto financing segment should consider taking advantage of market tailwinds to increase origination. In addition, they could evaluate other initiatives to boost profitability and increase dealer stickiness.

— *Holistically engage with dealers.* Lenders are seeing potential to engage with dealers across pricing, commercial financing, dealer incentives, and frontline-employee incentives. Enhanced dealer incentives can make the relationship stickier and marry frontline incentives effectively to dealer rewards. For example, some US banks are establishing real-time payments for dealers to enable same-day cash flow. Similarly, captives are working to get greater market share of floor plan financing, increasing dealer stickiness and penetration with programs such as GM Financial's Dealer Dividends.

— *Focus on used-car prime and higher-yield, near-prime customers.* Institutions that are not full-spectrum lenders and are skewed toward the upper end of the credit spectrum should focus on used-car prime and higher-yield, near-prime customers. The latter offer an opportunity to further assess partnerships with second-look financing vendors, as has been occurring in the mortgage industry.

— *Use a clean-sheet approach to pricing.* A clean-sheet approach takes a clinical view of current prices versus the competition and makes dynamic changes in response to such external factors as a rate change or a recession. Striking a balance between retaining margins and judiciously expanding or defending volumes helps ensure P&L impact.

— *Invest in digital, analytics, and automation.* Lenders should evaluate the potential of investments in digital and analytics tools, as well as automation across the value chain. A digital loan application on the front end helps create better dealer and customer stickiness. At the back end, investment in automation can help optimize operating margins, giving lenders a pricing advantage in a competitive market.

— *Keep a close eye on delinquencies and charge-offs.* As an asset class, auto financing has typically witnessed lower delinquencies and charge-offs than for mortgages, credit cards, unsecured personal loans, and other consumer asset classes. But amid scorching-hot inflation and interest rate increases, lenders still need to keep a close eye on any increases in delinquencies or charge-offs in this space.

— *Make strategic bets to be a part of the future auto ecosystem.* Lenders should explore newer partnerships outside the scope of traditional OEM dealerships—with multibrand and online retailers, for instance. One possible source of opportunities would be to develop capabilities to digitally integrate with the point-of-sale financing workflow at OEMs as they look to balance EV distribution between online sales and dealer networks.

— *Assess partnerships with platform aggregators and dealer groups.* Leading auto dealerships and retailers—both brick and mortar and online—either are exploring or have launched their finance and insurance offerings, as exemplified by Vroom's acquisition of United Auto Credit Corporation. Given that dealerships' primary goal in this area is to assure financing for their customers and drive sales volumes, this warrants an opportunity for financing players to explore the possibility of partnering with aggregators/platforms and midsize public- and private-dealer dealership networks.

— *Develop curated marketing and communication plans.* Lenders considering a new approach will need to educate dealers and frontline personnel on the change. This would require marketing and communication plans that deliver multiple bites at the apple. Achieving behavioral change takes time.

Along with considering these actions, auto financing players should make strategic bets with an eye to the future, given that the market is expected to expand significantly over the next few years. Such bets might focus on financing charging infrastructure for electric vehicles, advanced recreational-vehicle modeling to improve the lifetime of EV batteries, and innovative pricing models, such as renting vehicles by the mile and other subscription models.

The auto financing landscape has begun to shift. Now is an opportune time to reevaluate and update strategies and operating models. Lenders that act quickly can stay relevant and even increase their share of a changing market.

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