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Nuts and Bolts of Today's Auto Finance Market

This issue of *Consumer & Community Context* delves into the auto finance market. It unpacks the role of dealers, the different types of providers of financing, and the products available to auto buyers. The article also reviews the post-pandemic state of the market and potential consumer risks.[1]

Auto Finance and the Economy

Many consumers rely on cars in their day-to-day lives to take them to work, to bring their children to school or childcare, to attend classes, to reach healthcare appointments, and for various other uses. Cars are also among the most expensive purchases most households make, and the number of options to finance a vehicle—as well as the potential for hidden or unexpected costs—can be complex, even for financially savvy consumers.

Automobile debt accounts for nearly one-third of Americans' non-mortgage debt.[2] Consumers have several options to purchase or temporarily lease vehicles with financing, which are detailed below.[3] Auto financing is broadly available to a wide spectrum of borrowers, including those with lower credit scores and those looking to spread out payments over longer terms to reduce monthly costs.

The COVID-19 pandemic led to supply chain complications that reduced the supply of vehicles, leading to fewer cars available for purchase, higher prices for consumers who were able to secure vehicles, and a larger share of borrowers taking out longer-termed loans in order to reduce their monthly payment amounts. More than ever, it is important that auto buyers understand the auto market, including the types of dealers and lenders, as well as their roles in a purchase or lease transaction, the various financing products available, and potential risks to avoid.

Note: The views expressed here are those of the authors and do not necessarily reflect the position of the Federal Reserve Board or the Federal Reserve System.

[1] The staff contact for this issue is Kim Wilson and for the *Consumer & Community Context* series is John Rodier. Thomas Popeck Spiller provided research and analysis on this topic. Barbara Lipman and David Coffey provided editorial support.

[2] Federal Reserve Bank of New York, Consumer Credit Panel: https://www.newyorkfed.org/microeconomics/hhdc/background.html.

[3] This article reviews the types of financing available for consumers looking to acquire vehicles to own or lease. It does not discuss auto title financing, which is typically a loan of about $5,000 or less secured by a vehicle that the consumer already owns outright. Consumers use auto title loans for liquidity or to bridge income shortfalls, similar to how they may use a payday loan.

The Dealer Landscape

Auto dealers play an important role in facilitating the sale of vehicles to consumers. There are three main types of auto dealers: franchise dealers, independent dealers, and buy here, pay here (BHPH) dealers. Nearly all new vehicles and approximately half of used vehicles are sold through franchise dealers, while independent and BHPH dealers represent smaller segments of the auto market (table 1).[4]

Table 1. Types of auto dealers

Franchise dealers	Independent dealers	BHPH dealers
Franchise dealers are affiliated with a vehicle manufacturer and typically sell that brand's new vehicles. Some of these dealers also sell trade-ins from a variety of other manufacturers.	Independent dealers sell used vehicles from a variety of brands. These dealers include large national companies as well as small single-location dealerships and companies operating entirely online.	BHPH dealers are companies that both sell vehicles and finance the vehicles they sell. They tend to market themselves as serving borrowers with low or no credit scores and represent a small portion of the overall market.

Source: Experian Velocity.

The Auto Loan Market

As 80 percent of new and 38 percent of used vehicle sales were financed with either a loan or a lease in the first half of 2023, auto financing products are also essential to sustaining the vehicle market and enabling consumers to purchase vehicles.[5] Lenders hold vehicles as collateral for auto loans—meaning that the lender can repossess the vehicle if the borrower does not make their payments on time. These loans almost always have a set interest rate that is fixed throughout the duration of the loan. However, auto loans vary significantly by the length of the loan ("maturity"), interest rate, and other factors based on the borrower's credit risk and lenders' business strategies. For example, "prime" borrowers (those with credit scores of 660 or above) have slightly lower average loan maturities of 63 months as compared to "subprime" borrowers (those with credit scores below 660) whose average maturities are 67 months. However, the difference in interest rates is significant—prime borrowers pay an average of 7.5 percent, compared to subprime borrowers who pay about 14 percent, on average.[6]

There are four types of auto financing providers: banks, credit unions, captive finance companies that are subsidiaries of auto manufacturers, and non-captive finance companies (table 2). Banks have the largest share of auto loan originations overall, followed closely by credit unions and

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[4] Experian Velocity third quarter 2023 data, accessed October 30, 2023.

[5] Melinda Zabritski, "State of the Automotive Finance Market Q2 2023," Experian, August 31, 2023, https://www.experian.com/content/dam/noindex/na/us/automotive/finance-trends/2023/2023-q2-state-auto-finance-market.pdf, page 6.

[6] Experian Velocity third quarter 2023 data, accessed October 30, 2023. Generally, credit scores above 660 are considered "prime" and below 660 are "subprime."

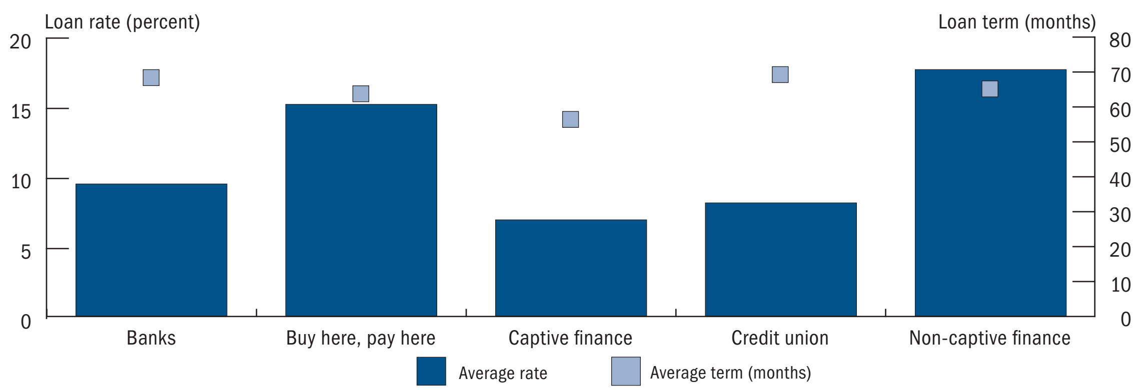
Table 2. Types of auto financing providers

Banks	Credit unions	Captive finance companies	Non-captive finance companies
Banks originated about one-quarter of auto loans in 2022. They tend to serve more prime borrowers and have lower delinquency rates than other provider types.	Similar to banks, credit unions originated about one-quarter of auto loans in 2022. Delinquency rates are also similar to those at banks.	Captive finance companies originate about one in five auto loans. They are subsidiaries of car manufacturers and mostly finance vehicles for their manufacturer, as well as new vehicles.	Non-captive finance companies are finance companies that are not affiliated with a parent bank or manufacturer.

Note: Market share figures are based on Experian Velocity 2022 data, accessed October 30, 2023. In addition to the shares provided in table 2, non-captive finance companies originated about 10 percent of auto loans and BHPH dealers originated about 6 percent of auto loans. Lender information is missing for about 7 percent of originations.
Source: Experian Velocity.

captive finance companies.[7] Captive finance companies are the largest financiers of new vehicles and may offer deals, such as zero-percent interest or cash back, subsidized by the manufacturer. Non-captive finance companies tend to finance used vehicles for subprime borrowers and usually offer loans with higher interest rates. BHPH dealers are a type of non-captive finance company that often both sell and provide direct financing for vehicle purchases and account for less than 10 percent of loans. Average interest rates and loan durations differ across lender types (figure 1).

Figure 1. Average loan rate and term by lender type



Source: Experian Velocity.

Direct vs. Indirect Auto Lending

Consumers may purchase vehicles via direct or indirect lending channels. With direct lending, a car buyer works directly with a lender (e.g., a bank or credit union) to secure a loan. If approved,

[7] Experian Velocity 2022 data, accessed October 30, 2023.

the lender provides the buyer with a letter of preapproval that they can use to shop for a vehicle. Alternatively, consumers may choose to shop for a vehicle first, obtain a draft bill of sale, and then apply for an auto loan directly with their lender.

In the indirect lending channel, the car buyer does not interact with the lender. Instead, the dealer facilitates the transaction by sharing the borrower's credit information with one or more lenders in the dealer's network. The dealer then receives offers from lenders with information about the terms (e.g., interest rate and maturity) under which they would finance the loan. The dealer chooses which offer to present to the customer.

Importantly, in indirect auto lending, the interest rate charged to consumers often includes two components: the buy rate and the dealer markup. The buy rate is the baseline interest rate that the lender will charge based on the consumer's credit risk. The dealer markup is an optional additional amount of interest that the dealer can add to the total interest rate that they quote to the consumer. This additional amount is intended to both compensate the dealer for facilitating the loan transaction and incentivize the dealer to choose that offer to present to the consumer.

Dealers choose whether to mark up a loan and by how much, within a range set by the lender. This discretion also introduces fair lending risk for creditors, which is discussed later in this article. The revenue from the markup is generally retained by the dealer; however, the markup revenue is sometimes split between the dealer and lender.

Leases and an Emerging Lease Alternative: Subscription Programs

Some consumers may choose to lease rather than purchase a vehicle. Auto leases are non-credit contracts between three parties: the lease provider (which is often a captive finance company), the company that owns the car, and the consumer.[8] Lease payments tend to be lower than loan payments because the lessee is paying for the depreciation that occurs during the lease term rather than the total vehicle value over a selected loan term. As a result, leases may allow consumers to obtain newer and more expensive vehicles than they would have been able to afford with a loan. Because leased vehicles are typically new, they usually have fewer maintenance issues, potentially reducing costs for the consumer compared to purchasing a used car.

Leases feature many tradeoffs compared to buying a car with a loan.[9] With a lease, consumers make monthly payments akin to a loan; however, they do not own the vehicle, so they have no equity at the end of the lease period. In contrast, a purchaser with a loan could make a profit when selling their car, assuming they have paid down their loan balance sufficiently. Lease

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[8] Banks, credit unions, and independent leasing companies also offer car leases.

[9] Jon Linkov, "Leasing vs. Buying a New Car," *Consumer Reports*, September 1, 2023, https://www.consumerreports.org/buying-acar/leasing-vs-buying-a-new-car-a9135602164/.

contracts typically set annual mileage limits (usually 10,000–15,000) and charge per-mile fees for mileage exceeding those amounts. Additionally, consumers may be responsible for any repairs beyond normal wear and tear when returning the vehicle at the end of their lease.

As alternatives to leases and loans, a select number of automakers and third-party providers have begun offering auto subscriptions. Auto subscriptions are similar to leases but tend to have comparatively higher monthly payments that include insurance, scheduled maintenance, and roadside assistance services. Under an auto subscription, consumers will typically pay an up-front activation fee as well as monthly fees, which vary from around $600 to over $1,000 per month for an established period of time (with mileage restrictions).[10] Consumers may opt for a subscription if they are looking for shorter-term access to a vehicle (such as one month, three months, etc.), the ability to switch vehicles after the subscription ends (or in some cases, even during the subscription term), or an all-in monthly payment that includes insurance and does not change.[11]

In addition to the emergence of subscription programs, the auto finance market has undergone significant changes since the onset of the pandemic.

Auto Loan Volume and Pricing in the Post-Pandemic Period

The economic effects of COVID-19 led to a significant growth in auto lending. After a temporary drop in 2020, the total volume of auto loan originations rose sharply as demand increased, and limited inventory caused new and used vehicle prices—and thus average loan amounts—to surge. The average amount financed for new and used vehicles rose during this period, and those higher prices and loan amounts gave way to higher payments as well, despite borrowers spreading out payments over longer-termed loans (figures 2 and 3).[12]

Rising prices were observed as plant shutdowns, parts shortages, and strong consumer demand for vehicles constricted new vehicle inventories.[13] Additionally, rental agencies cycled through less inventory over the same period, decreasing the supply of used vehicles flowing into the consumer market.[14]

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[10] John M. Vincent, "A Guide to Car Subscription Services," *U.S. News & World Report*, May 20, 2022, https://cars.usnews.com/cars-trucks/advice/guide-to-vehicle-subscription-services.

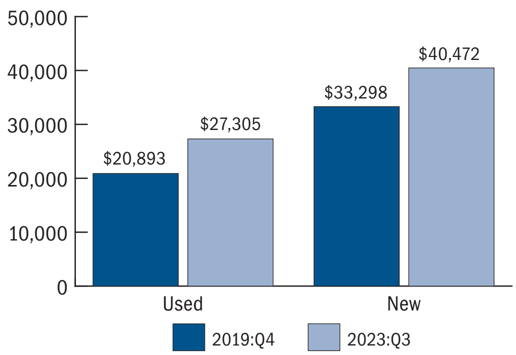
[11] Renee Valdes, "Should You Pay for a Car Subscription?," *Kelley Blue Book*, March 28, 2023, https://www.kbb.com/car-advice/car-subscription/.

[12] Experian Velocity data, accessed October 30, 2023.

[13] Morgan Korn, "'Out of Control': Buyers Paying Thousands over Sticker Price for New Cars," ABC News, January 29, 2022, https://abcnews.go.com/Business/control-buyers-paying-thousands-sticker-price-cars/story?id=82489039.

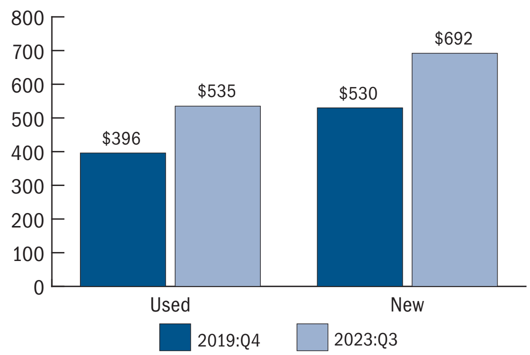
[14] Sean Tucker, "Rental Car Shortage Has Hertz and Enterprise Buying Used Cars," *Kelley Blue Book*, June 4, 2021, https://www.kbb.com/car-news/rental-car-shortage-has-hertz-and-enterprise-buying-used-cars/.

Figure 2. Average amount financed, 2019 vs. 2023



Source: Experian Velocity.

Figure 3. Average monthly payment, 2019 vs. 2023



Source: Experian Velocity.

New vehicle production has begun to increase slightly but remains below pre-pandemic levels.[15] While rising interest rates have begun to reduce demand for financing, which could contribute to somewhat lower vehicle prices, it remains to be seen how changes in the vehicle manufacturing process—including a shift to electric vehicles, incentives to open new plants in the United States, and disputes between auto companies and their workers—will impact pricing trends and new vehicle supply.[16]

Consumer Risks in Today's Auto Finance Market

Higher new and used auto prices are driving a rise in extended loan terms or loans with repayment terms of 84 months or longer. While the length of a typical car loan can vary based on the customer's credit profile, the type of lender, and other factors, these terms have typically lasted between 36 and 72 months. However, in recent years, consumers have increasingly taken out auto loans with longer terms. In the third quarter of 2023, 13.6 percent of new and 10.5 percent of used auto loans had terms of 84 months or longer.[17] These figures are well above the combined share of new and used vehicles with extended terms in 2019 at 4.8 percent of total originations.

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[15] Stephanie Brinley, "The Semiconductor Shortage Is—Mostly—Over for the Auto Industry," S&P Global Mobility, July 12, 2023, https://www.spglobal.com/mobility/en/research-analysis/the-semiconductor-shortage-is-mostly-over-for-the-auto-industry.html.

[16] Camila Domonoske, "The UAW Won Big in the Auto Strike—but What Does It Mean for the Rest of Us?," NPR, November 12, 2023, https://www.npr.org/2023/11/12/1211602392/uaw-auto-strike-deals-ratified-big-three-shawn-fain.

[17] Experian Velocity data, accessed October 30, 2023.

Extended terms can lower a borrower's monthly payments and are not inherently risky. However, there is some evidence that borrowers with longer-termed loans become delinquent at higher rates than borrowers with shorter-termed loans, regardless of credit scores.[18]

Longer loan terms increase the total cost of borrowing over time and may increase the amount of time that borrowers spend "underwater"—that is, when they owe more on their auto loan than the car is worth. The situation of borrowers who are underwater could worsen if vehicle supply increases quickly and vehicle values decline. Borrowers who are underwater and opt to sell or trade in their vehicle prior to paying off their auto loan may be more likely to roll the leftover loan balance into their next auto loan.

A longstanding potential risk to consumers relates to the sale of optional add-on products. Add-on products—such as extended warranties or cosmetic upgrades—are marketed or sold by lenders, dealers, or third parties. Consumers may opt to finance these products as a part of their auto loan. Some consumers may not be aware that they are being charged for add-on products or may not understand their terms and costs. Add-on products may provide little value to consumers or may cost much more than if they were provided by unaffiliated third parties.[19] Some financial institutions have rules governing the sale of add-on products that outline acceptable products and vendors and limit what share of loan proceeds can be attributed to add-ons, but this is not always the case.

Lastly, while also not a new compliance issue, interest rate markups in indirect auto loans may pose risks as well. When dealers present indirect loan offers to consumers, they do not always reveal whether the interest rate was marked up or by how much. While some financial institutions limit the scale of markups permitted on their loans, the dealer's ability to mark up the rate can result in violations of the Equal Credit Opportunity Act (ECOA) if markups are made on a prohibited basis, such as race or gender.

Conclusion

The auto market transformed in unforeseeable ways during the pandemic—and while future economic shocks cannot be predicted with certainty, it is likely that the cost of vehicle ownership will continue to strain some consumers' budgets for the foreseeable future. As such, it is important that consumers are knowledgeable of the various financing options available to them and bear in mind potential risks and benefits.

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[18] Zhengfeng Guo, Yan Zhang, and Xinlei Zhao, "Risks of Long-Term Auto Loans," *Journal of Credit Risk*, June 12, 2018, https://ssrn.com/abstract=3290841 or http://dx.doi.org/10.2139/ssrn.3290841.

[19] John Van Alst and Carolyn Carter, "Auto Add-Ons Add Up: How Dealer Discretion Drives Excessive, Arbitrary, and Discriminatory Pricing," National Consumer Law Center, October 1, 2017, https://www.nclc.org/issues/auto-add-ons-add-up.html.

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