**Auto ABS Not a Systemic Risk**

Despite more subprime delinquencies, most ABS continue to perform.

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**KEY INSIGHTS**

- We do not view asset-backed securities (ABS) backed by auto loans as a systemic risk to the financial system.
- Several characteristics of the auto ABS market are distinct from the subprime mortgage market leading up to the global financial crisis.
- Although there are areas of concern within the subprime auto ABS segment, we believe that the fundamentals of the overall car loan market remain strong.

Although recent press reports on asset-backed securities (ABS) backed by subprime auto loans have drawn parallels to the subprime mortgage market leading up to the global financial crisis, we do not view auto ABS as a systemic risk to the financial system. At the peak of the last cycle, mortgage debt outstanding in the U.S. was more than USD 11 trillion, not including the massive amounts of related derivative exposures. For perspective, despite the subsequent boom in auto lending, the amount of auto loan debt outstanding is still only approximately USD 1.3 trillion, and related derivative exposures are much more limited.

In contrast with subprime mortgages in the mid-2000s, auto loan underwriting standards are not deteriorating, the proportion of auto loan-backed ABS issuance relative to new auto loans has stayed fairly stable, the percentage of all new auto loans that are being made to subprime consumers is not increasing materially, and household balance sheets are broadly healthy enough to service the higher levels of auto debt.

**Rising Delinquency Rates**

That’s not to say that the auto ABS market is without risk, as evidenced by delinquency rates that have been rising at a moderate rate for the last few years. Depending on the structure of a particular ABS issue, delinquencies on the underlying collateral—in this case, auto loan payments—can lead to credit rating downgrades and investor losses for some slices, or classes, of the deal. We have found value in a limited subset of higher-quality subprime auto ABS from experienced issuers, who we meet with regularly and subject to thorough fundamental credit analysis.

**Auto Loan Underwriting Standards Steady**

There is little evidence that auto loan underwriting standards have deteriorated.

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**1.3 Trillion**

the amount (USD) of auto loan debt outstanding in the U.S.

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July 2019
In recent years, banks have reported that they have tightened standards on auto loans.

ABS and Subprime Lending Not Driving Boom in Car Loans

The amount of auto loans outstanding has been growing rapidly, reaching USD 1.28 trillion in the first quarter of 2019 as the percentage of Americans with a car loan climbed to 35% in 2018 from 20% in 1999.¹ A higher percentage of U.S. households now have a car loan than a home mortgage, although the total outstanding balance of auto loans is a small fraction of the more than USD 12 trillion in outstanding mortgage debt.

¹ Source for all auto loan market data: Federal Reserve Bank of New York.
However, the auto ABS market has not kept pace with this growth. Auto ABS issuance as a percentage of auto loan origination has stayed relatively constant since 2010, indicating that the ABS market is not facilitating the surge in auto lending. Again, this is unlike the subprime mortgage boom in the mid-2000s, when investor demand for higher-yielding subprime residential mortgage-backed securities helped fuel the housing bubble.

**Percentage of Auto Loans to Subprime Borrowers Staying Steady**

Along similar lines, the percentage of total new auto loans made to subprime borrowers (generally considered those with credit scores below 620–660) is not increasing. This is evidence that expansion in subprime lending is not driving the growth in overall auto loans, both prime and subprime. This contrasts with the pre-financial crisis home mortgage market, when the percentage of new mortgages that were subprime was growing rapidly and playing a major part in enlarging the entire mortgage market.

**Healthy Household Balance Sheets**

From a broader point of view, household balance sheets are generally healthy, giving most consumers the financial ability to repay their car loan obligations. Household leverage is meaningfully lower than it was in 2006 and 2007, when consumers ratcheted up their mortgage and home equity debt. Household

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**Fig. 3** Subprime Lending Not Driving Growth in Auto Loans

Loans to borrowers with FICO score below 620 as a percentage of total auto loan origination

As of March 31, 2019

![Percentage of Auto Loans to Subprime Borrowers](source)

**Fig. 4** Household Leverage Is Relatively Low

Household financial obligations relative to disposable personal income

As of March 31, 2019

![Household Leverage](source)
2.36% auto loans more than 90 days late as of the first quarter.

Financial obligations as a percentage of disposable income fell sharply following the financial crisis and has been relatively steady since about 2013.

While we do not think the auto ABS market presents a systemic risk, subprime lending has driven delinquencies on car loans higher, with 2.36% of auto loans more than 90 days late as of the first quarter. This was the highest delinquency rate since 2012.

Although there are areas of concern within the auto ABS segment, we believe that the fundamentals of the overall car loan market remain strong. Fundamental analysis of the underlying collateral’s credit quality, as well as the structure of an individual ABS deal, is essential for avoiding pitfalls in subprime auto ABS. We have exposure to subprime auto ABS in some of our taxable fixed income portfolios, and we focus on higher-quality issuers that have long track records.

WHAT WE’RE WATCHING NEXT

A U.S. recession would cause consumer balance sheets to deteriorate, changing our analysis about the ability of individuals to meet their car loan obligations. However, the current strength of the labor market and the still healthy gross domestic product growth rate in the first quarter give us reasonable confidence that the economy will avoid a recession in the near term. A meaningful deterioration in labor market conditions would likely prompt the Federal Reserve to ease monetary policy, which could extend the economic cycle.
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