Driving a hard bargain

Tighter credit in the district may be adding to the woes of auto dealers

By PHIL DAVIES
Senior Writer

Sales were sputtering last fall at Ken Vance Automotive in Eau Claire, Wis. Overall sales at the company's two dealerships declined 25 percent in September and October 2008 compared with the same period in 2007. On slow days, salespeople hit the phones in an effort to entice former customers into the showroom to kick the tires on new and used Buicks, Cadillacs, Hondas and Volkswagens. Only brisker business in parts and service kept the firm's General Motors-Hyundai operation in the black.

President Ken Vance blames the tough economy for most of the drop in vehicle sales, but he said that "the credit picture has obviously had a great bearing" on depressed sales at his dealerships.

The credit picture—the availability of auto financing—is anything but clear, and decidedly cloudy for some people who would like to buy a car. Many lenders have tightened their standards, especially for people with spotty credit histories. For customers with marginal credit, Vance said, "the odds were better a year ago than they are today" of securing an auto loan on terms that they could live with.

Slumping sales that worsened in the wake of the financial crisis—light vehicle sales in the United States fell 32 percent in October from the same month in 2007—are causing great distress in the automotive industry. GM and Chrysler have been pushed to the brink of bankruptcy, and auto dealers in the Ninth District and across the country are struggling for survival. In Minnesota, dealers shed 2,000 jobs in October, according to state employment figures.

Whether, and to what extent, tighter credit has contributed to the slump is the subject of intense debate by district auto dealers, manufacturers, lenders and other industry stakeholders. Are willing buyers walking out of dealerships because credit has become too expensive, the terms demanded by lenders too stringent?

Certainly the auto finance industry has become more averse to risk than it was a few years ago, when buyers with shaky credit could get seven-year loans with minimal money down. Auto credit markets were tightening even before the onset of the banking crisis in mid-September, thanks to rising default rates, the travails of domestic auto manufacturers and difficulties selling subprime auto debt to investors. Fewer auto loans were being written, and the share of new loans going to people with prime credit was increasing.

Lenders appear to have further tightened their purse strings since September. Concern that tight credit is stifling auto purchases and other consumer spending was the impetus for a Federal Reserve program announced in November to lend up to $200 billion to the holders of securities backed by consumer debt, including auto loans.

All of which doesn't mean that district consumers can't buy a new set of wheels today. For buyers with reasonably good credit, loans with good terms are still available from banks and the finance arms of many auto manufacturers. Even low-income, subprime borrowers may be able to secure financing from credit unions, which haven't appreciably tightened their credit standards and are expanding their auto lending.

Credit obstacle course

A collective shiver ran through the auto industry in October when GMAC Financial Services, the country's biggest auto lender, announced that it was taking a more conservative approach to auto financing. Henceforth, car buyers would have to score 700 or above on FICO (Fair Isaac Corp.'s yardstick of credit worth), put more money down and pay off the loan in less time. The changes—on top of higher interest rates introduced early in 2008—put GM vehicles and other autos financed through GMAC out of reach for millions of Americans with less than prime credit.

Sales of GM vehicles were already trending downward at Vance Automotive, but after GMAC's move, they plunged 32 percent in October compared with the previous October. Along with "unrealistic" interest rates, Vance said GMAC is "completely out of sight on the quality of the buyer, and the restrictions that they are throwing up." Soon after the new rules went into effect, a long-time customer with excellent credit walked away from a sale when GMAC demanded a 20 percent down payment on a used car.

GMAC's credit crackdown is only one of the most dramatic and recent examples of tautening auto credit. Many other auto lenders have been pulling in their horns for a year or more, lending less and paying much more attention to credit quality than in the past. Auto finance as a whole has become more conservative because of fallout from the subprime housing debacle and subsequent economic downturn, said Tom Libby, an analyst with J.D. Power and Associates, a national marketing research firm focusing on the auto industry. "Everybody has tightened up," he said.

Despite a large drop in the prime interest rate in 2008, the finance arms of the Big Three U.S. automakers raised their interest rates last fall. According to the Federal Reserve, the average annual interest rate for new loans financed by the subsidiaries, or "captives," of domestic auto lenders (a group that includes Ford Motor Credit and Chrysler Financial) was 6.2 percent in September. That's more than a percentage point higher than the rate in the third quarter of 2007.

The Fed data also show an increase in the average down payment required by the captives. The typical loan in September was for 85 percent of the vehicle's value—a sharp drop from 95 percent in July and well below the average loan-to-value ratio in this decade.

In addition to this general reeling in of credit by U.S. automakers, all three domestic captives cut back on low-inter-

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est incentive financing last year, and GMAC and Chrysler Financial retreated from the auto lease business.

No money down, no car!

A new caution in auto lending extends beyond the Big Three finance companies to banks and independent auto finance firms. JPMorgan Chase and AmeriCredit, a nationwide auto finance company, have reduced their auto lending and tightened their credit standards in the past year or so. Chase Auto Finance, the country's largest bank-owned auto financer, is demanding higher down payments and capping subprime loans at five years.

J.D. Power auto lending data show a broad tightening of credit standards in 2008 for a broad swath of the Midwest that includes Minneapolis-St. Paul and parts of district states Minnesota, Wisconsin and Michigan. Average auto-loan interest rates in the region declined year over year in October—the opposite of the Big Three trend. But the average down payment increased to over 21 percent of the purchase price (see top chart at right).

Small, independent banks in the district don't do much auto lending, and historically they have concentrated on serving existing customers with prime credit. But these banks appear to be following the lead of big banks in lending more conservatively. Bill Underriner, the owner of an auto dealership in Billings, Mont., noted that one local bank hiked its interest rates in October. "Don't worry, I was over there talking to them about it," he said.

In Minnesota, community banks have not appreciably tightened their standards for prime borrowers, said Marshall MacKay, CEO of Independent Community Bankers of Minnesota, which represents about 250 small banks in the state. But he added that local bankers have even less appetite for subprime, stand-alone auto loans than they had six months or a year ago.

Banks have also joined the captives in driving a hard bargain on commercial loans used for "floor planning," or dealer inventory. Restricted financing has left dealerships scrambling to buy vehicles to sell, said Scott Lambert, executive vice president of the Minnesota Auto Dealers Association (MADA). "The dealers are having a hard time getting credit on reasonable terms, and that is as big a problem as consumer credit right now," he said.

Keeping it loose

Timidity isn't universal in auto lending. Ford Motor Credit and the finance arms of foreign auto manufacturers haven't significantly raised their credit standards in the past year. These firms are financially healthier and have higher credit ratings—and therefore lower borrowing costs—than Chrysler and GMAC. Ford Credit spokesperson Meredith Libbey said that the firm began shedding risky loans in 2002, and so has seen no need to restrict credit further. "We have not tightened our standards; we've got good criteria and we're sticking by them."

Likewise, there's scant evidence of tightening at Toyota Motor Credit Corp. and Nissan Motors' finance subsidiary. Both firms launched zero-percent financing campaigns in October in a bid to wrest more market share from their Detroit-based rivals.

Another bright spot for borrowers is credit unions, which are aggressively pursuing auto lending. According to the Credit Union National Association, 31 percent of credit union loans nationwide are for autos, and in the first nine months of last year outstanding credit union loans for used vehicles (which accounted for more than half of auto lending) increased almost 6 percent. Flush with deposits and not weighed down by toxic mortgages, credit unions are disposed to lend, said Steven Rick, the association's senior economist. "Credit unions haven't tightened up their lending standards as much as their competitors, like the banks and captive finance companies," he said.

Interlakes Federal Credit Union in Madison, S.D., doubled its auto lending last year as its growing membership took out loans on new and used cars at interest rates 1.5 percent to 2 percent lower than the prevailing rate offered by area banks. General Manager Lynnette Taylor said that in most instances a FICO score of 650—50 points less than GMAC's cutoff for financing—qualifies borrowers for a five-year loan covering 90 percent of the vehicle's purchase price.

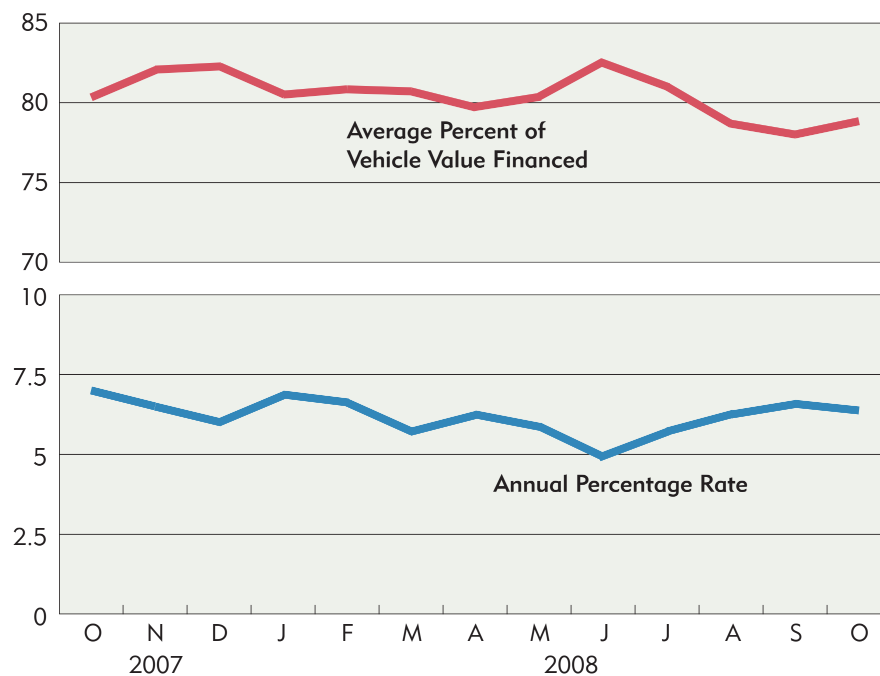
Nevertheless, the overarching trend in auto lending, both nationwide and in the district, is a migration from risk toward safety. Prime credit is desirable; anything less is to be handled gingerly, if at all.

One reason for this change is climbing delinquency rates. A recent report on automotive lending by Experian PLC, a multinational credit bureau, showed that in the second quarter of 2008 the number of loans 60 days past due was 11 percent higher nationwide than in the same quarter in 2007. District states have much lower rates of auto delinquency than the country as a whole, but Experian data suggest that auto delinquencies have also been creeping up in the region (detailed state statistics were unavailable).

The rise in delinquencies coincides with a shift in the quality ratio of new auto loans. Nationwide and in the district, lenders wrote more prime loans and fewer subprime loans in the second quarter of 2008 than they did the previous year, according to the Experian report. The subprime share declined nationally and in every district state (see chart above).

More recent Experian data were unavailable at press time, but it's probable that this flight to quality has accelerated since the banking crisis hit in September, hastened by the fragile finances of many lenders and problems selling subprime loan contracts in money markets leery of securitized consumer debt.

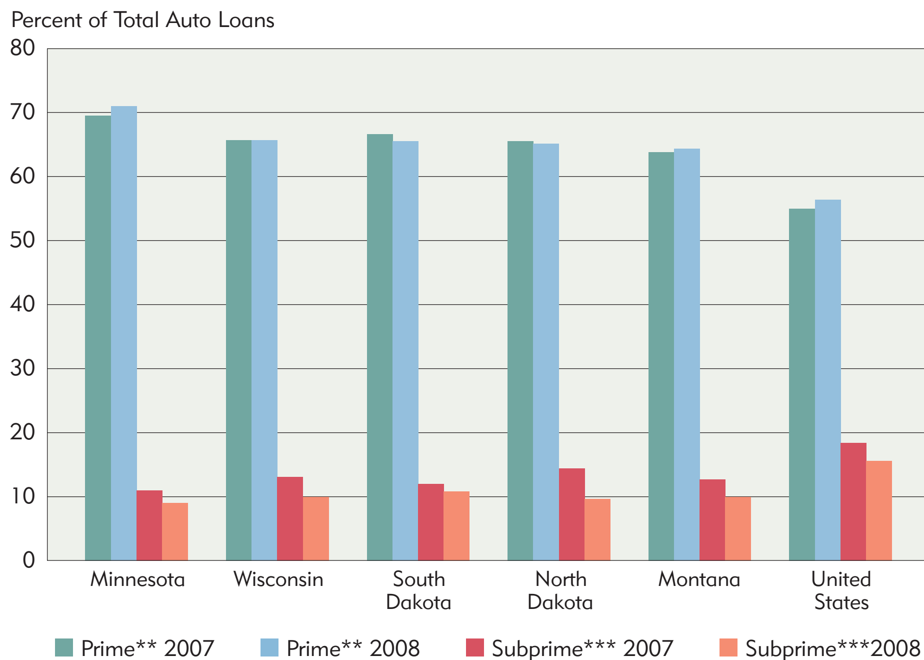
Auto Loan Terms in the Midwest*



*Includes Minneapolis, Chicago, Cincinnati, Cleveland, Columbus, Detroit, Indianapolis, Milwaukee, Pittsburgh and St. Louis

Source: J.D. Power Information Network

New Auto Loans by Risk Class*



*2007 and 2008, 2nd Quarter Data

**FICO score 680+

***FICO score 550–619

Source: Experian National Vehicle Database

Waiting for the thaw

So if you're pining for that new- (or used-) car smell, chances are the credit bar has been raised since you last set foot in a district showroom. Consumers with prime credit can buy the vehicle they want at a good price, because many dealerships are desperate to bring in revenue. However, depending on the lender and the borrower's FICO score, the loan contract may come with strings attached—a bigger down payment, a shorter loan term—than was customary for prime borrowers a year ago.

Drivers with less than sterling credit can still buy a vehicle, but they're likely to pay a lot more up front and face higher monthly payments on shorter loans. "People with spotty credit records are

going to have a harder time at least getting prime credit," said Lambert of MADA. "They may be paying more for their loan." For buyers with bad credit—a FICO score of 400 or lower—there's always the bus. As of November most auto lenders were rejecting those loans.

Consumer confidence will undoubtedly return when the national economy regains its footing, reviving the sagging fortunes of auto dealers in the district. The weekend after the presidential election, sales picked up at Ken Vance Automotive—a sign to the owner of rebounding consumer optimism following months of uncertainty about the direction of federal policy.

But dealers must be able to extend credit to their customers if they are to capitalize on pent-up demand for automobiles. No one knows whether the progressive tightening of auto credit that has occurred over the past year or two is temporary, or the beginning of a prolonged period of more conservative lending.

If major lenders continue to restrict credit, that could spell trouble for auto dealers in the district, leading to consolidation and higher prices because of reduced competition. In some district states the ranks of dealers have been thinning for a while. According to MADA, more than 60 dealerships have closed their doors in Minnesota over the past five years.

Just before Thanksgiving, six Denny Hecker Automotive dealerships shut down in the Twin Cities, resulting in 400 layoffs. Owner Denny Hecker attributed the closing to a "perfect storm" of financial misfortunes, including Chrysler Financial's decision to cut off his credit lines in October. f

Bringing the credit home

Expanded credit programs and lending from the Minneapolis Fed

By DANIEL ROZYCKI
Associate Economist

The issue of credit availability is an especially important one to the Federal Reserve. In response to concerns about the health of the financial sector, the Fed has significantly expanded its programs for providing liquidity to markets since the fall of 2007. Although most of this credit has been borrowed by financial institutions outside the Ninth Federal Reserve District, the district has been more than a mere spectator. Historically a significant source of discount window lending, the Federal Reserve Bank of Minneapolis continues to take an active role in providing additional funds to district financial institutions.

The Fed has made credit more widely available by both expanding old lending programs and creating new ones. (See "Actions to Restore Financial Stability," by Niel Willardson, in the December 2008 issue of *The Region*, at minneapolisfed.org.) Lending at the discount window—the Fed's traditional source of credit for depository institutions, including banks, thrifts and credit unions—was expanded by increasing maximum loan maturities and lowering the relative costs of borrowing.

In addition, the Term Auction Facility (TAF) was introduced in late 2007 to offer a new format—sealed bid auctions—for allocating discount window credit to depository institutions, including community banks common to the Ninth District. (Under the emergency authority granted by Section 13(3) of the Federal Reserve Act, the Federal Reserve also created several new facilities to extend credit to nonbank financial institutions normally not eligible for discount window credit. However, no firms in the Ninth District have borrowed through these programs. For more background on Section 13(3), see "The History of a Powerful Paragraph," by David Fettig, in the June 2008 issue of *The Region*.)

Under these expanded programs, the Minneapolis Fed's lending to district financial institutions has increased rapidly over the past year. In a normal year, total lending from the Minneapolis discount window rarely surpassed $100 million. But in 2008, it peaked above $1 billion.

In addition, district borrowing under the new TAF has skyrocketed. The total balance from outstanding loans at the end of October 2008 was $5.2 billion greater than in October 2006, according to the Minneapolis Fed's weekly balance sheets (Federal Reserve Statistical Release H.4.1: Factors Affecting Reserve Balances). That's an increase of more than 100-fold over the average reported level in 2006. It also accounts for almost 10 percent of the growth in total liabilities (including deposits and other funding sources) among commercial banks in the Ninth District from third quarter 2007 to third quarter 2008.

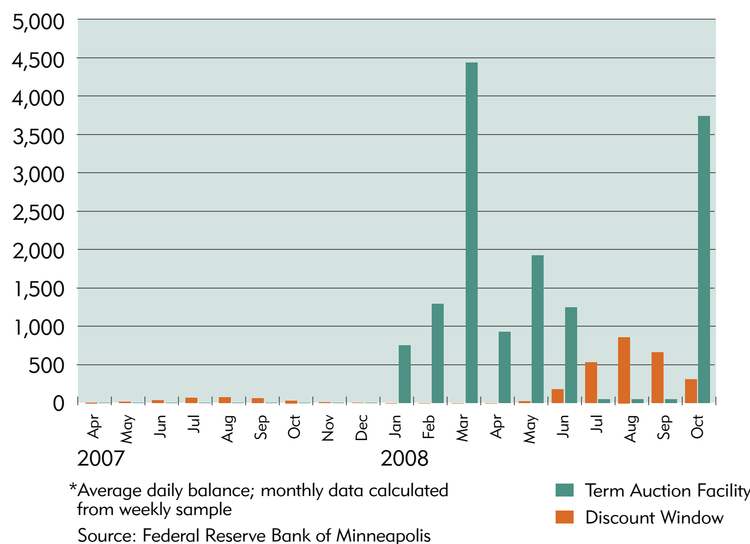
Despite the rapid rise in Fed lending in the Ninth District, such lending rose even faster in other parts of the country. At the end of October 2008, nationwide lending through traditional programs was 275 times greater than the average reported balance from 2006 (from $340 million to $110 *billion*). Such large figures swamp even the eye-popping increase in district lending.

The extensive borrowing elsewhere is a reversal of long-standing patterns. Historically, when overall Federal Reserve lending was much smaller, the Minneapolis Fed's share of discount window lending was disproportionately high—sometimes as high as 40 percent of the national total.

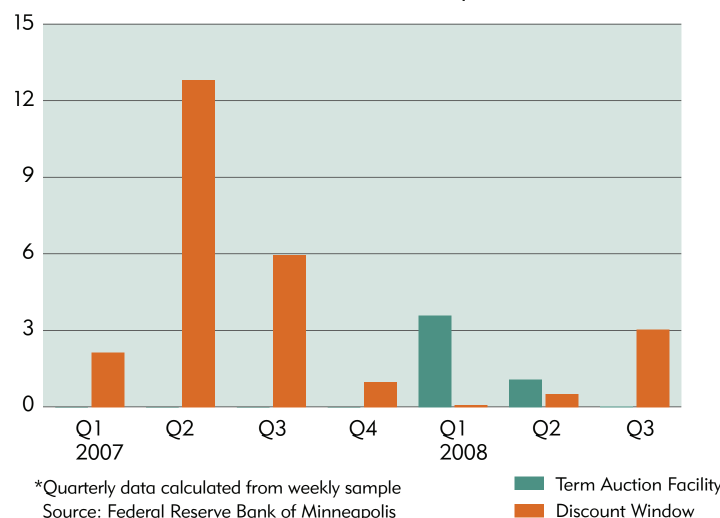
Much of the Minneapolis Fed's lending normally happens during the summer months, much of it through the seasonal lending program, which targets smaller banks with highly seasonal funding needs, typically for agriculture or tourism. But in 2008, the district's share of lending through traditional discount window programs surpassed 10 percent for only one week.

Lending activity through new credit facilities is also much greater outside the district. Nationally, outstanding TAF credit recently surpassed $300 billion. The largest share—and typically well more than half—of those loans has been issued out of the New York Fed. But every Federal Reserve district has had some borrowers over the past year. Though the share of TAF credit funneled through the Minneapolis Fed has hovered below 5 percent, the total dollar amount dwarfs other Minneapolis Fed discount window programs (see charts).

Historically, the Minneapolis Fed has played a significant role in discount window lending. New national credit programs have prompted a huge increase in Federal Reserve lending in the past year, and the Minneapolis Fed's proportion of such lending has dropped as a result. But under the circumstances, that's a market share it doesn't mind losing. f



*Average daily balance; monthly data calculated from weekly sample
Source: Federal Reserve Bank of Minneapolis



*Quarterly data calculated from weekly sample
Source: Federal Reserve Bank of Minneapolis

Home to roost

As the housing mortgage industry reevaluates creditworthiness, some players and markets are shrinking, while others see opportunity

By JOE MAHON
Staff Writer

By all accounts, much of the current turmoil in financial markets originated in the housing market. Following years of booming home sales, facilitated by looser credit and alternative financing for riskier borrowers, the housing market started to cool. Prices declined; then a lot of mortgage debt began to go bad.

The subsequent fallout in the broader economy has been the subject of considerable attention and debate. But it's also worth circling back to see if credit conditions have changed in the business sector where this all got started.

The sheer drop of homes bought and sold might imply a horrific credit crunch in home mortgages. That's not the case: Mortgage credit is still available, and at mortgage interest rates that remain cheap by historical comparison (see chart below).

But the housing tumult has convinced the mortgage industry to adopt new, and typically more stringent, credit standards. According to the Federal Reserve Board's October survey of senior loan officers, 85 percent of banks reported tightening standards for conventional mortgages and 100 percent are tightening subprime standards.

Traditional mortgages are still available to borrowers with good credit if they're willing to jump through more hoops. But investors that undergird the home-loan market have stopped buying up exotic and riskier mortgages, and those mortgage products are either going up in price or going away altogether. Other sectors like second mortgages and home equity loans have also been affected, but sources say that even those loans are still available from some lenders, for the time being. And as certain portions of the home-loan market fall away, other smaller lending sources are finding room to grow.

Financial crash course

At first glance, a mortgage seems like any other loan; banks lend money from bank deposits to borrowers looking to buy a house. But that only describes a small—and until recently, shrinking—segment of the market.

There are thousands of mortgage lenders nationwide. But most of the funds being borrowed ultimately come from a handful of very large investors—like Citibank, GMAC and Wells Fargo—that ultimately determine the mortgage terms and credit standards that borrowers must meet.

Banks also used to keep home loans on their books, but that's less common today. Instead, they typically sell mortgages (usually pooled as mortgage-backed securities) in the secondary markets. This replenishes lendable funds and maintains liquidity for the next person looking for a mortgage.

The secondary market is dominated by Fannie Mae and Freddie Mac, which are so-called government-sponsored enterprises (GSEs) and whose standards for buying loans influence overall mortgage lending conditions. But the housing slump also sent Fannie and Freddie into government conservatorship after both nearly collapsed.

Tight fit

The broader point here: Primary and secondary financial markets that fund most mortgages have been in turmoil, and as these credit markets change, so do retail mortgage products.

Take conventional loans, for example. They are still widely available, but the standards to qualify for one have risen. For example, both Fannie Mae and Freddie Mac have tightened requirements and now want larger down payments. And the degree of price discrimination has become finer; two high-quality borrowers with slightly different credit scores might now pay quite different rates on identical mortgages, where before they might have been in the same pricing category. These changes are called loan-level price adjustments.

The shift in mortgage products is much more obvious among nonconventional mortgages—particularly subprime, Alt-A (which has risk between prime and subprime) and jumbo mortgages (which finance more expensive homes). In 2006, subprime and Alt-A mortgages made up 33 percent of new mortgage loans, according to an October 2008 report by Freddie Mac. But skyrocketing loan defaults have been a death-knell for these mortgage niches. Through the first half of 2008, the share of these nonconventional loans plunged to just 3 percent, and most anecdotal evidence suggests the market continues to throw dirt on most nonconventional mortgage products.

"The Alt-A, subprime, stated income—all those markets completely went away," said Paul Schuster, a mortgage lender in Edina, Minn.

The reason is simple: Realizing they had badly mispriced the underlying risk of these borrowers, financial markets became unwilling to finance these mortgages any longer. Annual issuance of subprime and Alt-A mortgage-backed securities—which provide liquidity in these markets—went from close to $800 billion in 2006 to effectively zero through the first six months of 2008, according to the Freddie Mac report.

The disappearance of these alternative mortgages hasn't bothered many

real estate agents and lenders in Montana and the Dakotas, where such products were not very prevalent. Housing markets in cities like Fargo, N.D., and Billings, Mont., have slowed, but not much in comparison with major markets nationwide. Many attribute that stability both to the absence of earlier housing bubbles and to conservatism on the part of lenders and borrowers.

"We're pretty old-school here, and there wasn't a lot of demand for anything outside the 30-year fixed mortgage," said Steve Tucker, a mortgage broker in Billings.

Jumbo mortgages are also in a tough spot because GSEs cannot buy jumbo loans, or those valued at over $417,000. Their market share has fallen as well, from 16 percent in 2006 to 6 percent in 2008, as financing in the secondary market dried up. However, Congress passed emergency legislation last February that temporarily raised the loan limit to $730,000 in high-cost regions of the country, before lowering it to $625,500 for 2009 mortgages.

When the new limits went into effect, "rates for jumbo borrowers in high cost areas plunged" by more than one percentage point, according to a press release from Freddie Mac. However, don't bother looking for those higher jumbo limits around here; all high-cost designations lie outside the Ninth District. And because those loans are typically for prime borrowers, the jumbo mortgage market reflects more signs of a classic credit contraction, because "investors (have) dried up, as opposed to the demand," said Schuster.

Credit conditions are also tightening for second mortgages and home equity loans. These loans, which allow homeowners to borrow against their home equity, were widely credited for fueling strong consumer spending for a decade leading up to the housing collapse.

But now it's not as easy to get those loans. Though many banks still offer such products, anecdotal evidence and recent surveys by the Minneapolis Fed (see cover story) suggest they've been scaled back. In the Federal Reserve System's two most recent quarterly surveys (July and October 2008) of senior loan officers, three-quarters of the nation's banks reported tightened lending standards for revolving home equity lines of credit. Slightly more than one-quarter of domestic banks reported weaker demand for this type of credit in October, more than double the fraction in the July survey.

The victors

Tighter lending conditions have provided an unexpected boost to some players in the mortgage market. Home sales might be down, but they haven't vanished altogether.

Credit unions and community banks have been beneficiaries of the shift. Since these firms primarily keep their loans in-house, they aren't as affected by conditions in the secondary market. "The credit union industry as a whole has not felt anywhere near the crunch that the commercial banking industry has," said Paul Scherman at WESTconsin Credit Union in Menomonie, Wis. WESTconsin makes more conventional loans that can still be sold to Fannie and Freddie, but also offers adjustable-rate mortgages and equity loans that cannot.

The data show that rather than running away from the housing market, credit unions have been running toward it. From September 2007 to September 2008, the amount of real estate loans outstanding with the nation's 7,900 federally insured credit unions grew 15 percent, according to data from the National Credit Union Administration, the federal agency that charters and supervises federal credit unions. At $300 billion in mortgages (third-quarter annualized rate), credit unions expanded in all areas over this period. Fixed-rate mortgages saw particularly strong growth (20 percent), but balloon/hybrid and adjustable-rate mortgages were also higher over this period, as were home equity lines of credit.

Home Federal, a community bank in Sioux Falls, S.D., has started making in-house jumbo loans because the secondary market prices them prohibitively high. "We decided to go out and set aside a few bucks so that we could handle some of these jumbo products and offer the people a competitive rate," said Gary Weckwerth, vice president for mortgage banking at Home Federal.

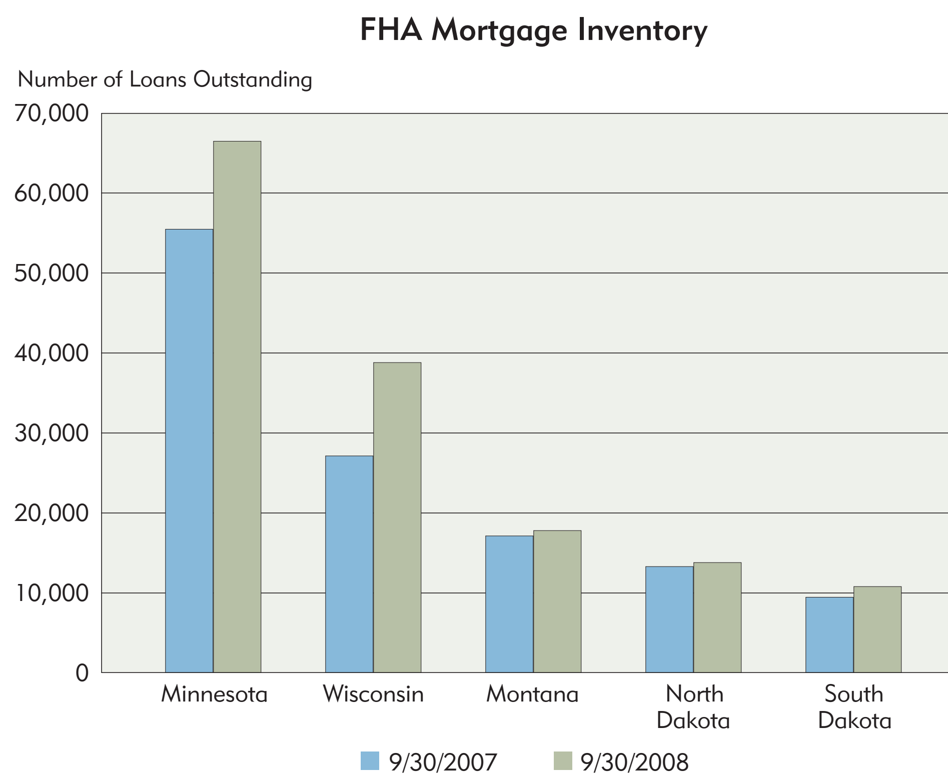
Loans backed by the Federal Housing Administration have also spiked in response to market developments. The FHA is an insurance fund run by the U.S. Department of Housing and Urban Development. HUD works with a network of mortgage lenders that it certifies. Those lenders can make 30-year fixed-rate loans to qualified borrowers that are then insured by the FHA. Insurance premiums are part of the mortgage payment.

FHA-insured loans are low risk and have traditionally been an inroad for first-time buyers and others for whom homeownership might not otherwise have been an option. But FHA lending started to decline with the rise of subprime and Alt-A loans, which provided even greater access to financing at a lower cost for the same type of borrowers.

"We weren't getting borrowers into FHA loans, and borrowers that had FHA loans were refinancing in a mass exodus," said Anita Olson, an official at HUD's Minneapolis office.

The number of FHA loans in Minnesota declined from 221,000 in 1995 to 55,000 in 2007. But now that those alternatives aren't as readily available, FHA loans have increased in district states (see chart above). Nationally, FHA loans have increased from 3 percent of mortgages to 17 percent.

For mortgage lenders that are FHA-certified, this business has become bread-and-butter; those who aren't certified are forced out of this market niche. "We kind of took [subprime] out of the marketplace," said Ron Jordan at State Bank and Trust in Fargo, which does mostly FHA and conventional 30-year fixed-rate mortgages. "We're up about 20 percent over last year."



Where credit is due

Like credit markets nationwide, mortgage credit might best be described as a qualified seek-and-ye-shall-find market—if you shop around, and if you have good credit. If you don't, your options appear more limited than they once were because markets have been forced to recalibrate how they price borrower risk.

Despite the housing slump, the Mortgage Bankers Association acknowledged on its Web site that "the marketplace is working. The volume of many nontraditional products is down because investors, rating agencies and lenders have tightened underwriting standards."

As such, borrowers, lenders and the many interrelated parties involved in the mortgage industry are adjusting to tighter credit standards, and no one knows for sure whether they are temporary, wait-and-see temporary or permanent.

The outlook for the housing market brightened in late November when the Federal Reserve announced a program to increase liquidity in the mortgage finance industry by purchasing $100 billion in GSE debt and up to $500 billion in mortgage-backed securities issued by Fannie Mae, Freddie Mac and Ginnie Mae. The impact was immediately favorable, as interest rates on 30-year fixed-rate mortgages dropped more than a full percentage point.

Whether lower mortgage rates hold and what effect they might have on the housing market is hard to predict, and many in the industry are wary of trying to anymore.

Jordan, from Fargo, expressed optimism for the Fargo region, but he was less bold in assessing how the market might perform going forward. "I'd say I can't imagine it getting worse, but a year ago I'd have said I couldn't imagine a lot of what's going on now." f