Ben Bernanke’s “quantitative easing” has pumped trillions of dollars into the financial system. It also has sparked an explosion in subprime auto lending.

Autos for everyone, courtesy of the Fed

By CARRICK MOLLENKAMP
JASPER, ALABAMA, APRIL 3, 2013
Thanks largely to the U.S. Federal Reserve, Jeffrey Nelson was able to put up a shotgun as down payment on a car.

Money was tight last year for the school-bus driver and neighborhood constable in Jasper, Alabama, a beaten-down town of 14,000 people. One car had already been repossessed. Medical bills were piling up.

And still, though Nelson’s credit history was an unhappy one, local car dealer Maloy Chrysler Dodge Jeep had no problem arranging a $10,294 loan from Wall Street-backed subprime lender Exeter Finance Corp so Nelson and his wife could buy a charcoal gray 2007 Suzuki Grand Vitara.

All the Nelsons had to do was cover the $1,000 down payment. For most of that amount, Maloy accepted Jeffrey’s 12-gauge Mossberg & Sons shotgun, valued at about $700 online.

In the ensuing months, Nelson and his wife divorced, he moved into a mobile home, and, unable to cover mounting debts, he filed for personal bankruptcy. His ex-wife, who assumed responsibility for the $324-a-month car payment, said she will probably file for bankruptcy in a couple of months.

When they got the Exeter loan, Jeffrey, 44 years old, was happy “someone took a chance on us.” Now, he sees it as a contributor to his financial downfall. “Was it feasible? No,” he said.

The Maloy dealership wouldn’t discuss the loan. “I got nothing to say to you,” an employee said.

At car dealers across the United States, loans to subprime borrowers like Nelson are surging – up 18 percent in 2012 from a year earlier, to 6.6 million borrowers, according to credit-reporting agency Equifax Inc. And as a Reuters review of court records shows, subprime auto lenders are showing up in a lot of personal bankruptcy filings, too.

It’s the Federal Reserve that’s made it all possible.

In its efforts to jumpstart the economy, the U.S. central bank has undertaken since November 2008 three rounds of bond-buying and cut short-term interest rates effectively to zero. The purchases of mostly Treasury and mortgage securities – known as quantitative easing and nicknamed QE1, QE2 and QE3 – have injected trillions of dollars into the financial system.

The Fed isn’t alone. Central banks from Tokyo to Frankfurt to London are running their printing presses overtime. The heavily indebted advanced economies are trying to reflate their way out of the prolonged bout of crisis and recession that crystallized with the collapse of Lehman Brothers Holdings Inc in 2008. That crisis, of course, followed a nearly decade-long cycle of easy money and exotic financial products that itself began with the collapse of the tech-mania bubble of the late 1990s.

The Fed’s program, while aimed at bolstering the U.S. housing and labor markets, has also steered billions of dollars into riskier, more speculative corners of the economy. That’s because, with low interest rates pinching yields on their traditional investments, insurance companies, hedge funds and other institutional investors hunger for riskier, higher-yielding securities – bonds backed by subprime auto loans, for instance.

Lenders like Exeter have rushed to meet that demand. Backed by Wall Street banks and big private-equity firms, they have been selling ever-greater amounts of subprime auto loans in the form of relatively high-yield securities and using the proceeds to fund even more lending to more subprime borrowers.

Expansion of the subprime auto business was chronicled in a 2011 Los Angeles Times series. Since then, growth has continued apace. Consider that in 2012, lenders sold $18.5 billion in securities backed by subprime auto loans, compared with $11.75 billion in 2011, according to ratings firm Standard & Poor’s. The pace has continued so far this year, with $5.7 billion of the securities issued, compared with $4.4 billion for the same period last year, according to Deutsche Bank AG. On Monday alone, three deals totaling $1.6 billion of subprime auto securities were announced by Wall Street banks.

To make up for the risk of taking on increasing numbers of high-risk borrowers, subprime auto lenders charge annual interest rates that can top 20 percent.

The Exeter loan Nelson and his wife got, for example, carried a 21.95-percent rate. Exeter, which is majority-owned by private-equity giant Blackstone Group, assumes that one in four borrowers will default on their loan, according to an Exeter investor pitch book reviewed by Reuters.

“Exeter works with auto dealers throughout the country to help consumers who do not qualify for prime financing,” a company spokeswoman said. “Exeter offers conventional financing with affordable payments tailored to each customer’s individual circumstances.”

A Blackstone spokesman declined to comment.

**Bubble Trouble**

Critics of the Fed say the growth in subprime auto lending is just one of several mini-bubbles the bond-buying program has created across a range of assets – junk bonds, subprime mortgage securities, and others. The yield chase delivered big

Text continues on page 4
Under the hood

The Fed’s massive monetary stimulus since the 2008 financial crisis has fed a resurgence in the subprime auto-lending business as investors have chased higher-risk, higher-yield securities backed by such loans, in turn driving down yields relative to safer investments.

![Graph showing yield to maturity of top-rated prime/subprime auto loan securities compared with 2-year Treasurys](image)

**SALE OF SUBPRIME AUTO-LOAN SECURITIES**

**SUBPRIME AS A PCT OF TOTAL AUTO-LOAN SECURITIES ISSUANCE**

Sources: Barclays Plc (yield to maturity); Standard & Poor’s (sale); Deutsche Bank (pct of total); Thomson Reuters Datastream (2-year Treasury)
windfalls to some Wall Street firms and hedge funds holding securities that soared in value. But so much money has flowed into these assets, the critics say, that the markets for some are beginning to resemble the housing boom in the run up to the financial crisis.

“It’s the same sort of thing we saw in 2007,” said William White, a former economist at the Bank for International Settlements. “People get driven to do riskier and riskier things.”

White is among the growing number of economists coming round to the view of Federal Reserve Bank of Dallas President Richard Fisher, a non-voting member of the central bank’s policy-making panel and a longtime critic of quantitative easing. “We are sailing deeper into uncharted waters,” Fisher said in a speech six days after the Fed’s Sept. 13 announcement of QE3. “Why would the Fed provision to shovel billions in additional liquidity into the economy’s boiler when so much is presently lying fallow?”

A bust in the subprime auto market wouldn’t have consequences nearly as devastating for lenders, investors or the broader economy as the housing bust did. Securities underpinned by subprime auto loans, estimated at about $80 billion between 2006 and 2012, are a fraction of the $1.6 trillion in mortgage-backed products Wall Street created between 2006 and 2009, according to S&P data and the Financial Crisis Inquiry Commission, created by the U.S. government to analyze the financial crisis.

And whatever its faults, the Fed’s program, consistently supported by most members of the central bank’s policy-making body, has helped pull the U.S. economy out of recession and boosted the stock market to record levels.

In congressional testimony last month, Fed Chairman Ben Bernanke, the main proponent of the bond-buying program, said low interest rates have “helped spark recovery in the housing market and led to
increased sales and production of automobiles and other durable goods.”

Indeed, auto sales have recovered to nearly pre-crisis levels. New car, pickup truck and sport-utility vehicle registrations are projected to increase 6.6 percent this year to 15.3 million, according to automotive market-analysis firm Polk. Registrations could exceed 16 million in 2015, a number last seen in 2007.

A Fed spokesman declined to comment.

Subprime auto loans may seem like an obscure corner of finance, but the names behind the expansion are familiar.

Santander Consumer USA Inc, a unit of giant Spanish bank Banco Santander SA, is one of the biggest sellers of securities backed by subprime auto loans, according to S&P. In 2011, KKR & Co, Warburg Pincus and Centerbridge Partners bought a 25 percent stake in the Santander unit for $1 billion.

Capital One Financial Corp, General Motors Co and Ally Financial Inc are also steadily increasing loans to subprime borrowers.

**PERFORMANCE ANXIETY**

Less well-known upstart Exeter, founded in 2006 and based in Irving, Texas, is run by executives from AmeriCredit Corp, an auto-finance company acquired by General Motors in 2010. It reported $100 million in originations in May 2010. It expected to hit $1 billion in 2012 and $2.2 billion by 2015, according to the pitch book. The company has grown to 46 branches with 532 employees serving more than 6,600 dealers, from one branch and six employees serving 120 dealers in 2006.

In 2008, a Goldman Sachs Group Inc fund, through an investment in a private-equity fund, helped infuse money into Exeter. Then, in 2011, Blackstone bought its controlling stake, turbo-charging Exeter’s expansion as the Fed decided to keep pumping money into the economy. In October, Wells Fargo & Co, Citigroup Inc, Deutsche Bank AG and Goldman agreed to provide it loan commitments totaling $1 billion.

After the Blackstone deal, in particular, the push was on for Exeter to expand its loan book, according to a former employee.

“Everybody was under extreme pressure to hit goals,” this person said. “Your job is in jeopardy. It was not sugar-coated.”

To win more business from dealerships, Exeter lowered its “holdback fee” – the small fraction of the loan amount that the lender keeps as a cushion against losses – to between $395 and $495 from about $795.

The August 2012 Exeter investor pitch book touts the firm’s “highly sophisticated risk management process,” which employs a “decision science” system underpinned by “predictive models.” The marketing book adds: “The end result is to deploy tools to management allowing for precision control over credit performance.”

This process results in customers with an average credit score of 556 and average annual income of $38,393, according to the pitch book. These borrowers pay an average interest rate of 21.4 percent a year. (Median U.S. household income was an inflation-adjusted $50,054 in 2011, according to the Census Bureau. On the widely used FICO credit-scoring scale, produced by Fair Isaac Corp, 640 or less is considered subprime.)

As for those Exeter clients who fall behind on payments, another former Exeter employee said, “They’re check to check.”

**TITLE LOANS, PAYDAY LENDERS**

That’s the case for Wayne Loveless.

Loveless and his wife in January 2012 got an Exeter loan to buy a 2006 Buick Rendezvous from Victory Nissan in Dickson, Tennessee.

But Loveless, working as a cook at the local O’Charley’s restaurant, had trouble keeping up with the $329 monthly payment. In February last year, the family got a title loan secured by a 2001 Ford Windstar van. In May, subprime lender World Finance gave them a $1,500 loan, secured by a television, a PlayStation and a DVD player.

Court records show that Loveless took out payday loans totaling about $5,500 from AmeriCash, ACE Cash Express and Cash In A Wink. (Payday loans, which are short-term loans secured only by the borrower’s future work pay, and title loans, also short-term but secured by an auto title, are a popular but expensive route to ready cash for many strapped Americans.)

Loveless said some of that money helped cover car-loan payments and some went toward the cost of caring for his wife’s mentally disabled brother. “It’s stressful because... you’re always begging for more money,” he said.

In July, Loveless and his wife filed for Chapter 7 bankruptcy, which erases unsecured debt and calls for liquidation of assets to pay down remaining debt. At the time, Loveless owed Exeter $9,900, excluding the value of the car.

Loveless recently lost his job as a cook and now works for a company that services fire extinguishers. He and his wife kept the Buick.

As the Lovelesses were struggling last year, Exeter issued $500 million in securities backed by subprime auto loans in two sales, in February and September. (Whether the Loveless loan was part of those sales couldn’t be determined.)

Like subprime mortgage securities issued in the past decade, each Exeter security was divided into tranches, or layers, based on the risk and return of each. Investors couldn’t get enough of them, bidding up prices and thus lowering yields. In February, the yield on the top-rated tranche was 2.029 percent. By September, demand had increased so much that the yield was just 1.312 percent.

## UNEASY MONEY AUTOS FOR EVERYONE, COURTESY OF THE FED
Ratings agency DBRS gave the least-risky tranche its top rating – triple-A – in part because Exeter used a cushion to protect investors against losses and because it had a management team experienced in subprime, the agency said in its ratings reports. Exeter’s proprietary model “declines approximately 50 percent of submitted applications,” the agency said.

MOODY’S WEIGHS IN

Moody’s Investors Service, in a move rare among ratings agencies, issued a report in March 2012 saying it would not have assigned a high investment-grade rating to the notes. “Exeter is small and unrated, with limited experience and little asset performance history,” it said.

Chuck Weilamann, a senior DBRS official, declined to comment on the Moody’s report. He said DBRS was comfortable with the rating, noting that of the $142 million top-tier notes backed by subprime auto loans in the first sale, half had been paid off. “It is performing in line with expectations,” he said.

Regardless of the relative safety of such securities, a rapidly growing lending business that bakes into its assumptions a 25 percent failure rate is almost certain to result in more people defaulting on more loans. In 2011, Exeter Finance was listed as a creditor or participant in 252 bankruptcy proceedings, according to an online database of federal court filings. In 2012, the number increased to 1,144.

Brett Wadsworth, the lawyer in Jasper who handled Jeffrey Nelson’s bankruptcy, said the bulk of the filings he works on involve subprime debt – loans his clients shouldn’t have gotten in the first place. “Most of them that’s getting those types of loans are the same ones who’s getting the cash loans or payday loans or title loans,” Wadsworth said.

Charles Thomas, an electrician in Park Forest, Illinois, filed for Chapter 7 bankruptcy only four months before he took out loans from Exeter and Santander in November 2011.

Efforts to buy a car failed at six different dealers, but an online car-loan application he had filled out prompted an employee from Family Hyundai to call: Thomas had been preapproved.

Thomas settled on a 2012 Hyundai Sonata financed by Exeter. His wife got a 2008 Hyundai Sonata financed by Santander. “They presented both deals to me at the same time,” Thomas said. “You begin to try to rationalize, well maybe it was our time for the sun to shine on us.”

A Family Hyundai employee said the dealership doesn’t comment on individual customers. Santander Consumer, citing privacy concerns, declined to comment.

After his wife lost her job at a logistics company, the $900 in monthly car payments proved to be too much. Thomas in February filed for Chapter 13 bankruptcy protection, which would allow him to reorganize his debts.

Thomas’s bankruptcy court filing lists personal property of $25 in a checking account, $1,000 in household goods and $300 in clothing and a retirement account valued at $24,000. It also shows he owes $22,060 to Exeter, and $11,538 to Santander.

AN APPETITE FOR RISK

Despite the risk that borrowers like Thomas present, investors have proved increasingly willing to put their money into subprime auto debt for lower relative returns. According to Barclays Plc, the average spread – a measure of investors’ risk tolerance – between top-rated securities underpinned by prime and subprime auto loans and a benchmark interest rate hit 0.32 percentage point in February. That represents a remarkable increase in risk appetite from the 8.85-percentage-point spread at the peak of the financial crisis in autumn 2008.

With so much investor money backing subprime auto loans, and the resulting expansion of lending to questionable borrowers, some market watchers are beginning to sound alarms – albeit muted ones. Fitch Ratings in March said it was “concerned that the competitive landscape is creating an environment that encourages lenders to compete by easing credit terms.”

Concerns are arising inside the business, too. At the annual American Securitization Forum conference in Las Vegas in January, Goldman Sachs banker Robert McDonald said persistent bullishness in pooled auto debt “worries me a bit.” Noting the narrowing of spreads, he said investors in subprime auto debt might ultimately balk if not paid enough to take on the risk.

In Alabama, Jeffrey Nelson continues to drive a bus for the Walker County school system and to work as a constable for his neighborhood. His financial struggles continue, too. “It’s one hit after another,” he said recently at a local mall restaurant over a dinner of bourbon-glazed chicken – some of it packed up for later. “Three days ago, I lost my iPhone. Had to buy another.”

Court records show Nelson has monthly income of $1,592.97, while monthly expenses total $1,563.00, leaving about $29 in his wallet. His ex-wife got the Suzuki SUV.

He still owns a 1996 Dodge Ram pickup truck. If he can scrape together the money, he said, he’ll buy blue lights and a siren to put on the truck for his work as a constable.

Edited by Paritosh Bansai and John Blanton

FOR MORE INFORMATION

Carrick Mollenkamp
carrick.mollenkamp@thomsonreuters.com

John Blanton, Enterprise Editor
john.blanton@thomsonreuters.com

Michael Williams, Global Enterprise Editor
michael.j.williams@thomsonreuters.com