Reconsider Your Appetite for Subprime Consumer Loan Risk

By Steve Hoke

Even the steady consumer loan growth in recent years probably still can't erase the conservative lending mindset most credit unions adopted in the wake of the Great Recession. "Subprime" still has an ominous connotation, spilling over from the mortgage side.

But if you're not giving serious consideration to increasing your subprime consumer loan portfolio, you could be leaving substantial loan growth and interest income on the table. You could also be missing an opportunity to build brand loyalty by helping people rehabilitate their credit scores and escape the predatory lending cycle.

Two key factors in the lending marketplace point to increased potential for subprime loan growth and profitability:

- **Increasing adoption of mobile banking:** For many subprime borrowers, convenience is critical and the traditional lending process isn't how they prefer to do business. Mobile devices suit their needs.

- **A strong, stable auto lending market:** According to Experian[1], the total dollar volume for outstanding automotive loan balances grew by $92 million from the second quarter of 2014 to the second quarter of 2015—the largest dollar volume growth since 2006. The increase brought the total auto loan balance to a record $932 billion.

  Loan quality didn't suffer during this growth. Experian's report showed that the 30-day delinquency rate of 2.32% was the lowest Q2 rate in the past five years, down from 2.37% in Q2 2014. The 60-day delinquency rate was up very slightly, from 0.603% in Q2 2014 to 0.607% in Q2 2015.

Don't be satisfied to ride along with the national trend of increasing vehicle loans. A strong mobile lending platform and a more receptive approach to the subprime market can help you attract high-yield auto loans from a core of young members.

Reach Out to Underbanked, Mobile-Enabled Consumers

Unbanked and underbanked consumers are key targets for buy-here-pay-here auto lenders, finance companies, and payday lenders. A fast, convenient lending process is typically an important selling point for these lenders.

Having a sound mobile lending platform is a good tactic for any type of loan growth today. It's especially important when you're seeking a foothold within the population hard-working, time-pressed subprime borrowers. And they're more attached to mobile devices than you might think.

A March 2015 report by the Federal Reserve[2] estimated the share of underbanked consumers—those who have a bank account but also use an alternative financial service such as a payroll card, payday lender, check casher, pawn shop, or auto title loan—at 16.9% of all consumers in 2013.

Among these underbanked individuals, 88% had a mobile phone, 64% of which were smartphones. Almost 39% of this underbanked population reported having used mobile banking in the previous 12 months.

Also keep in mind that most mobile device users overall are (or soon will be) in their prime borrowing years. The Fed's survey showed that of the mobile phone users who had used mobile banking within the last 12 months, 39.1% were 18 to 29 years old, and 33.7% were 30 to 44.

Is your website optimized for mobile devices? Do you offer a mobile lending app that streamlines the lending process?

The Subprime Yield Advantage

Let's compare the interest income from a subprime and a super-prime used-car loan, using Experian's average Q2 2014 interest rates: 3.53% for super-prime (VantageScore 740+) and 14.15% for subprime (550 - 619).

Say both loans are $15,000 with a 60-month term. If both are paid off in 60 months, you earn interest of $1,384.64 from the super-prime loan and $6,011.50 from the subprime.

What about charge-offs? Even if we use a 1% C/O rate for super-prime 20% C/O for subprime, the difference for 100 loans paid off in 60 months looks like this:

- **Interest for 100 super-prime loans:** $138,500 - $1,385 in charge-offs = $137,115
- **Interest for 100 subprime loans:** $480,880 - $96,176 in charge-offs = $384,706

In addition to generating a higher average loan yield, subprime borrowers may also be a source of young, loyal member families that can leverage these loans to improve their financial futures.

According to a 2015 Equifax report, "Subprime Auto Loans: A Second Chance at Economic Opportunity":[3]

- The credit scores of consumers who received a subprime auto loan (Equifax Risk Score of under 550) in June 2010 had increased by a median of 52 points as of June 2013.
- Compared with consumers who had less than a 550 credit score but didn't get auto loans, the group that did get these loans were *four times more likely* to have raised their credit score above 640 after three years.

The subprime auto loan market should be a good fit in many ways for the credit union industry's mission of people helping people, as long as risk is managed prudently. This market should at least be a serious topic of discussion during strategic planning for 2016.

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[1] "EXPERIAN AUTOMOTIVE: Auto Loan Balances Grow at Fastest Rate Since 2006," ©2015 Experian Information Solutions Inc.

[2] "Consumers and Mobile Financial Services 2015," the Board of Governors for the Federal Reserve System

[3] "Subprime Auto Loans: A Second Chance at Economic Opportunity," © 2015, Equifax Inc.