

Q2 2016

# An Updated Pricing Approach for New Vehicle Financing

## AT A GLANCE

- Trends in MSRP and new vehicle prices
- Segment-level ratio of new vehicle price to MSRP
- Misalignment of finance amount, MSRP and vehicle price
- The value of real-world insight



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## Introduction

As a general rule, lenders' automotive finance decisions are based on a consumer's credit profile. Lenders consider the probability of receiving payments on time over the lifetime of the loan, as well as the vehicle's price and the requested finance amount.

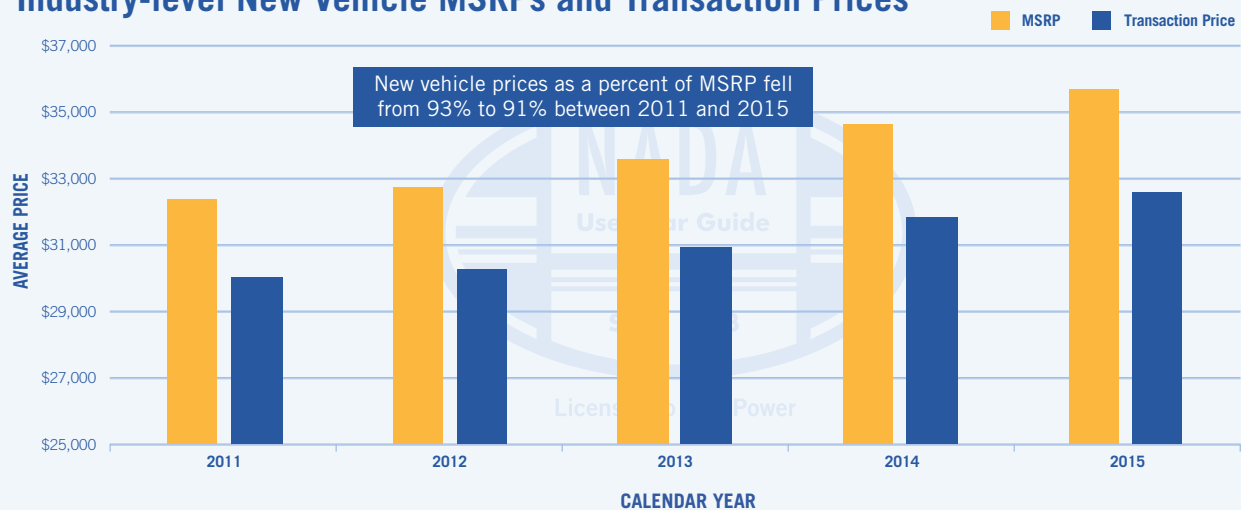
Consumers with a checkered credit history might receive less favorable financing terms, and might not be able to finance the full cost of the vehicle being purchased. Conversely, consumers with sterling credit records get lower interest rates and are often able to finance more than 100% of the vehicle's value. Lenders use the same basic process when extending credit for both new and used vehicles—but with a notable difference in the method for gauging collateral value.

For used vehicles, lenders rely on a partner such as NADA Used Car Guide to provide vehicle values

based on a rigorous analysis of actual transaction prices. Because values are market-based, they vary with supply and demand, time of year, age and mileage. That's why NADA Used Car Guide values provide a reliable, accurate and continually updated assessment of used vehicle prices.

Lenders approach new vehicle assessments differently. Rather than using a market-based benchmark, lenders tend to rely on the manufacturer's suggested retail price (MSRP) or dealer invoice price to determine new vehicle loan thresholds. However, MSRP and dealer invoice price reflect automaker pricing expectations more than contemporary market activity. As a result, lenders tying loan parameters to these prices don't have a true sense of how their finance amounts relate to actual transaction prices.

### Industry-level New Vehicle MSRPs and Transaction Prices



Industry-level New Vehicle MSRPs and Transaction Prices | Source: Power Information Network® (PIN) from J.D. Power

Figure 1

This report examines the lender practice of using MSRP or dealer invoice price to assess new vehicle value, and how a market-based approach to new vehicle prices can help reduce unforeseen risk.

## New Vehicle Financing: Decisions Influenced by “Suggested” Pricing Information

It’s a common risk management practice for lenders to assess the viability of a requested new vehicle loan amount by comparing it against either MSRP or dealer invoice price. A 2015 NADA Used Car Guide survey revealed that some credit unions and lenders use the full MSRP or dealer invoice price as their lending benchmark, while others add or subtract a percentage of one of those prices to set their benchmark. And

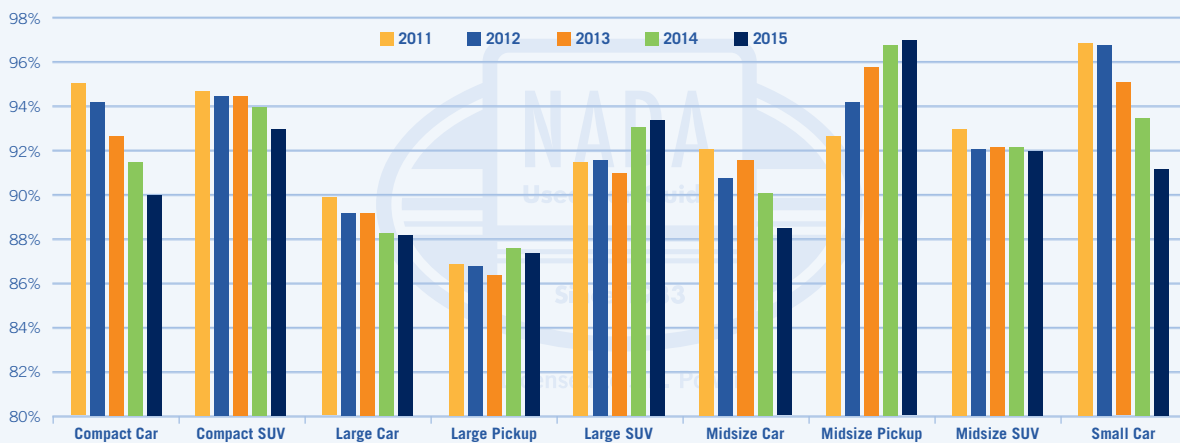
acceptable finance levels are further stratified by consumer credit profile. For example, lenders may finance up to 110% of a vehicle’s MSRP for a consumer with an excellent credit history, but only 90% of MSRP for a consumer with a blemished record.

While it’s prudent to compare requested loan amounts with some form of pricing benchmark, MSRP and dealer invoice price are largely static in nature and infrequently reflect the ebb and flow of actual sale prices. A comparative analysis of MSRP and new vehicle transaction price data derived from the *Power Information Network*® (PIN) from J.D. Power illustrates this point.<sup>1</sup>

An industry-level comparison reveals that MSRPs have been on the rise over the past several years, increasing by just over 10% from 2011 to 2015 (figure 1, page 2). New vehicle prices including

### New Vehicle Price-to-MSRP Ratios, by Segment

Average new vehicle sales price divided by average MSRP.



New Vehicle Price-to-MSRP Ratios, by Segment | Source: *Power Information Network*® (PIN) from J.D. Power

Figure 2

<sup>1</sup> The PIN provides real-time automotive information and decision-support tools based on the collection and analysis of daily new and used vehicle retail transaction data from thousands of automotive franchises.

customer cash rebates also increased during this period, but the 8.4% improvement was roughly 2 percentage points lower than the rise in MSRPs.<sup>2</sup> The disparity in price growth, dictated in part by a 7% rise in consumer cash incentives, pushed the spread between MSRPs and new vehicle prices up from 7% in 2011 to nearly 9% in 2015. (Viewed another way, new vehicle transaction prices averaged 91% of MSRP in 2015, down from 93% in 2011.)

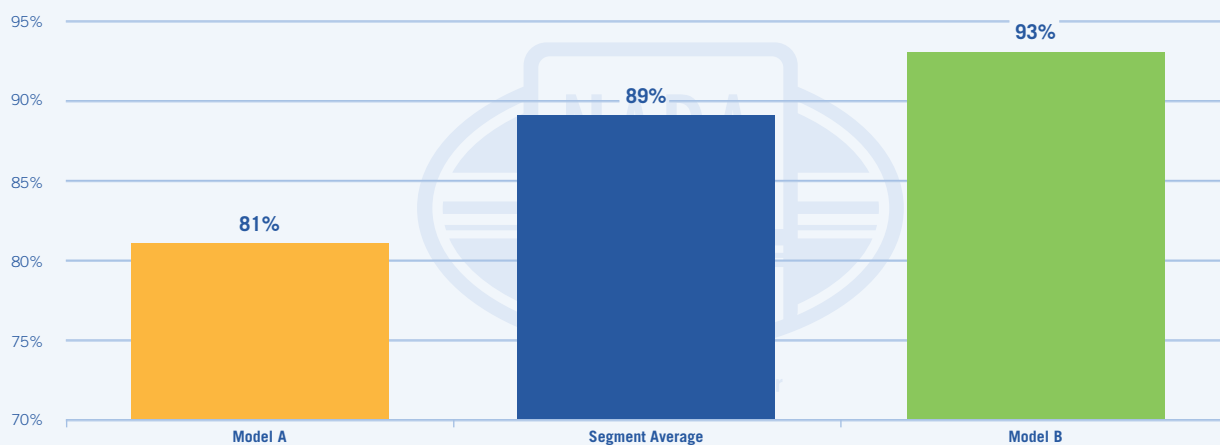
The difference between the two sets of prices is arguably minor at an industry level, but much more substantial when viewing data across segments. As seen in figure 2 (page 3), compact car transaction prices averaged 90% of MSRP in 2015, a 5-percentage-point loss from 2011, while the small car segment suffered an even worse 6-point decline. Conversely, midsize pickup prices gained 4 points over the period.

Figure 2 also illustrates how new vehicle price ratios vary significantly across segments. The same principle holds true when data is viewed at a brand or model level. Take two models from a high-volume segment, for example. Model A's new price ratio reached 81% over the first quarter of 2016, while Model B's ratio was 93%—a substantial 12-percentage-point difference (figure 3).

Assuming equal loan-to-value (LTV) parameters and finance amounts, Model A's lower ratio exposes a lender to increased risk, should the consumer default. Consider a lender who finances two \$25,000 vehicles at 95% of MSRP, with the amount of credit extended totaling \$23,750. Using the new vehicle price ratios from above, actual market prices for Model B would average \$23,277, while prices for Model A would average a considerably lower \$20,353. Assuming equal depreciation rates, the latter vehicle theoretically

### New Vehicle Price-to-MSRP Ratios, by Model

Model year 2016 vehicles sold in Q1 2016.



New Vehicle Price-to-MSRP Ratios, by Model | Source: Power Information Network® (PIN) from J.D. Power

Figure 3

<sup>2</sup> Vehicle prices referenced are the price the customer pays for the vehicle and for factory- and dealer-installed accessories and options contracted for at the time of sale, adjusted by the trade-in allowance and any available customer cash rebates. Price data is derived from all sales types, which include cash, finance and lease transactions.

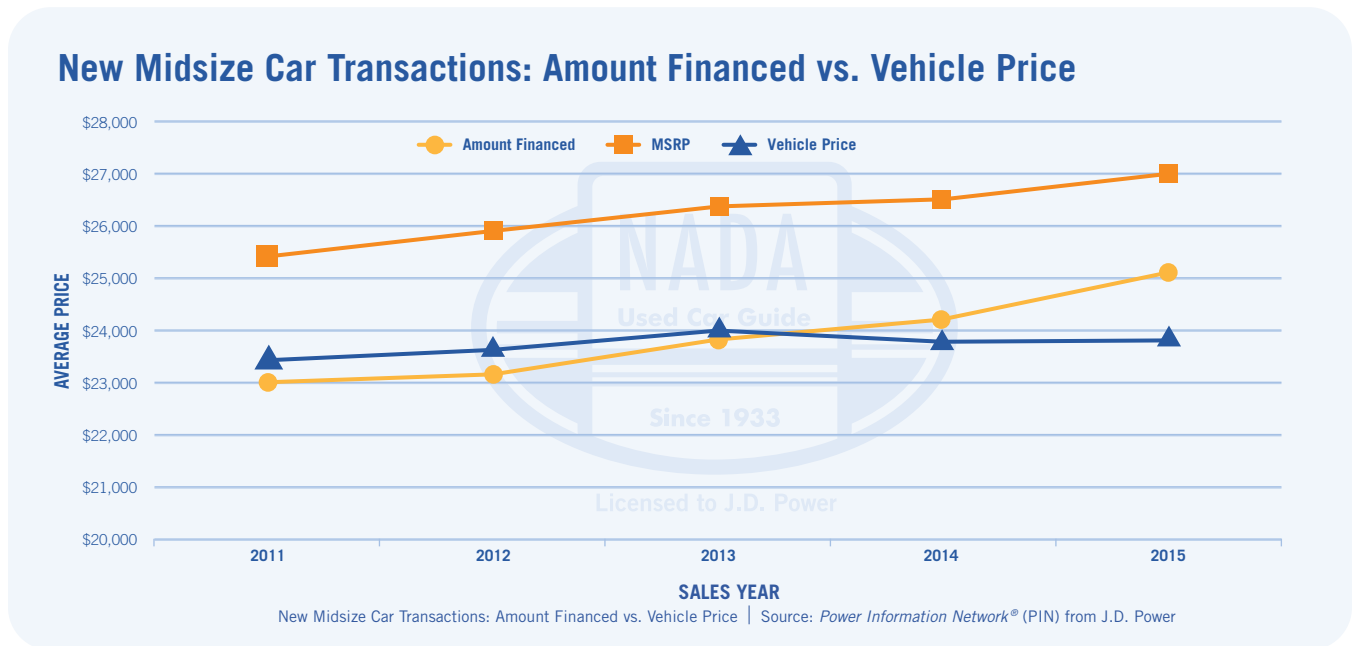


Figure 4

places the lender at a nearly \$3,000 disadvantage, relative to the former one, should both be repossessed and resold at auction in the future.

Ideally, the price disparity between the two vehicles should be reflected in the requested finance amounts. But while incentives and other discounts reduce the likelihood of soliciting the same finance amount for the cheaper vehicle, the *potential* for it to occur remains when adhering to similar MSRP- or dealer invoice-based LTV parameters. The misalignment of finance amount, MSRP and vehicle price is currently evident in the compact, midsize and subcompact car segments. PIN data shows that while finance amounts, and to a lesser extent MSRPs, remain up, vehicle prices are moving lower. For example, new midsize car transaction price and finance amount averages were similar from 2011 to 2013. In 2014, however, finance amounts began moving above

market prices, with the ratio of the two reaching 108% in Q1 2016 (figure 4).

Without a doubt, transaction prices for these car segments are under pressure from extreme competition, low gasoline prices and a shift in consumer preference toward trucks and utilities—for which the manufacturer solution is higher incentives. For example, J.D. Power and Associates data shows that automakers spent an average of more than \$3,530 per unit on midsize car incentives in 2015, an amount close to what was spent on more expensive premium midsize utilities.

Increasing finance amounts are due to a variety of factors, including lower down payment amounts, higher negative equity being rolled into the new loan, or simply lender aggressiveness. Per PIN data, for example, down payment amounts on new midsize car sales financed through

### NADA Used Car Guide's New Vehicle Values vs. Vehicle Price and MSRP

Model year 2016 midsize car.

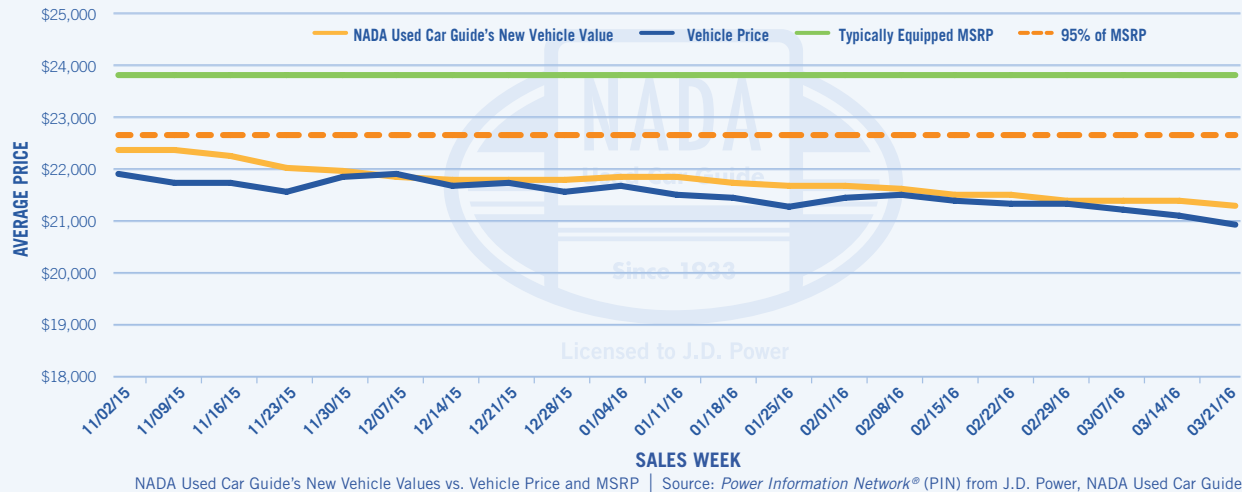


Figure 5

participating dealerships fell by an average of 6% per year from 2013 to 2015, while the percentage of trade-ins with negative equity jumped from 36% to 46% over the period.

Factors aside, the exercise helps illustrate that without some check rooted in real-world market activity, the practice of tying finance thresholds to MSRP or dealer invoice price can increase lender risk exposure when market factors begin to skew toward the negative.

## NADA Used Car Guide's New Vehicle Values: Real-world Insight

A “one-size-fits-many” approach to assessing new vehicle finance points can introduce added, and likely unexpected, risk to lenders. To help

address the issue, lenders should consider incorporating a transaction-based solution such as NADA Used Car Guide's [New Vehicle Values](#) into their current processes.

Rooted in new vehicle sales data collected through the PIN, New Vehicle Values provide a more accurate representation of where prices really are, as opposed to a preliminary suggestion of pricing made prior to the start of new-model-year sales.<sup>3</sup> Figure 5 provides a good example of this.

At no time over the period shown did new vehicle prices for the 2016 midsize car used in the example average close to MSRP. In fact, transaction prices failed to exceed 95% of MSRP in the fall of 2015, or early in its sales cycle, and as of March 2016 prices had fallen to roughly 89% of the arbitrary MSRP threshold. In contrast, New Vehicle Values closely reflected actual

<sup>3</sup> NADA Used Car Guide provides Low, Average and High New Vehicle Values that represent a typical range of what a new vehicle will sell for, based on actual market transactions and market influencers. NADA Used Car Guide supplies a range of values because local demand, dealer incentive programs and credit availability inherently cause price variations in the new vehicle market.



transaction prices over the entirety of the vehicle's sales cycle. A lender using a market-based metric such as New Vehicle Values is better positioned to assess the true extent of collateral risk than one adhering to a more inflexible MSRP- or dealer invoice-based methodology.

As demonstrated earlier, two apparently similar models can in fact carry substantially different risk profiles. Because New Vehicle Values are created at the vehicle level, they offer an individualized, realistic account of a vehicle's risk profile by reflecting its unique characteristics, including optional equipment, as well as sales performance.

## Conclusion

While times have been good for new vehicle sales and financing over the past few years, more challenging conditions appear to lie ahead. J.D. Power and Associates predict that after rising by 6% in 2015, new vehicle sales will increase by just 2% this year and only 1% in 2017. The slowing rate of growth increases the likelihood that manufacturers will become more aggressive with incentives. The 10% rise in incentive spending in the first quarter of 2016 supports this notion.

While MSRPs may continue to grow, higher discounts will place downward pressure on new vehicle prices. For example, PIN data shows that MSRPs moved 1.5% higher in Q1 2016 versus Q1 2015; however,

transaction prices were up by a lesser 0.7%. Negative equity has been trending up as well. The share of new vehicle sales containing a trade-in with negative equity reached 31.3% in Q1, a more than 2-percentage-point increase from Q1 2015. The growth in negative equity is due in part to lower used vehicle prices. Driven mostly by higher supply, used vehicle prices fell by more than 3% over first 3 months of the year, and NADA Used Car Guide expects prices to fall by 5% to 6% by year's end.

The less favorable new and used vehicle price environment increases the importance of making informed collateral pricing decisions for lenders. As evidenced by the rise in negative equity mentioned earlier, a higher rate of depreciation, combined with increasingly longer loan terms, means it will take consumers longer to reach a point of positive equity in new vehicle loans.

Lenders can mitigate some of the risk associated with lower equity levels by fine-tuning the amount of credit extended on a new automotive loan at origination by complementing current processes with market-based data such as [New Vehicle Values](#). The insight gained would allow lenders to better assess the risks and opportunities associated with a given new automotive loan, and in turn, improve their ability to profitably navigate the road ahead.

# About NADA Used Car Guide

## NADA Used Car Guide

Since 1933, NADA Used Car Guide has earned its reputation as the leading provider of vehicle valuation products, services and information to businesses throughout the United States. Its team collects and analyzes over 1 million combined automotive and truck wholesale and retail transactions per month, and delivers a range of guidebooks, auction data, analysis and data solutions. NADA Used Car Guide, a division of J.D. Power, provides a seamless view of timely, reliable new and used vehicle price information that helps automotive/truck, finance, insurance and government professionals make better business decisions. Visit [nada.com/b2b](http://nada.com/b2b) to learn more.

## NADA Used Car Guide's Lender Advantage

Getting ahead is going to get harder, but Lender Advantage is here to help. Our team of experts provides a full suite of vehicle analysis services that put you in the fast lane so you can keep up with marketplace changes. From vehicle risk assessments to portfolio analysis, remarketing planning and stress testing, we'll give you the data and insight you need to make the best business decisions. Depend on Lender Advantage for better outcomes. Visit [nada.com/advantage](http://nada.com/advantage) to see how we can help your business.



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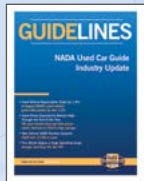
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# Additional Resources



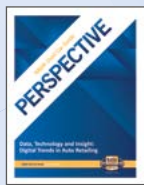
## NADA Guidelines

Updated monthly with a robust data set from various industry sources and NADA Used Car Guide's own proprietary analytical tool, NADA Guidelines provides the insight needed to make decisions in today's market. Sign up to receive NADA Guidelines monthly at [nada.com/guidelines](http://nada.com/guidelines)



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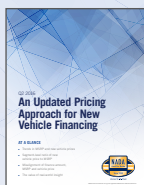
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Updated twice per week by Senior Analyst Chris Visser, the Commercial Truck Blog provides real-time analysis of incoming sales data from the industry's leading used truck sales database. Join the conversation at [nada.com/commercialtruck](http://nada.com/commercialtruck)



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