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SFA Research Corner

Auto ABS: Ready to Handle Rough Credit Terrain Ahead

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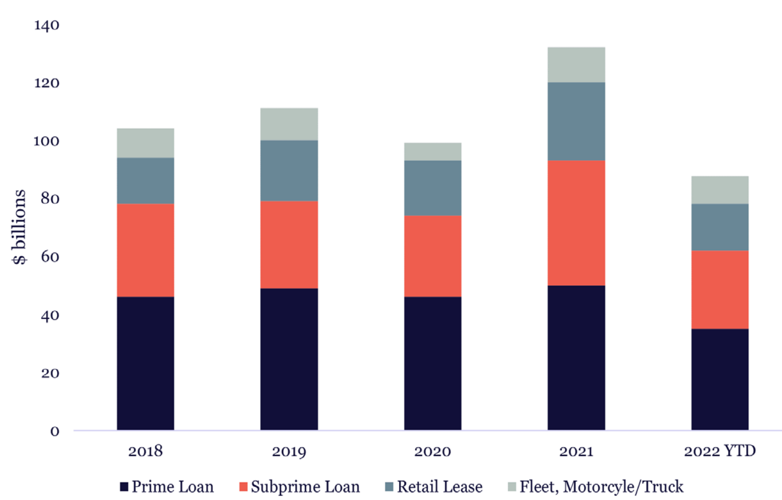
Auto ABS: Ready to Handle Rough Credit Terrain Ahead

Lender accommodation programs and an unprecedented level of government support during COVID added hundreds of dollars a month to the consumer's wallet and helped keep many of them current on debt obligations. As the last of these end, and to the extent prices of autos, food and consumer goods remain at or near current highs, consumers will have to reprioritize how they spend the money in their shrinking wallets. A wave of missed payments across all consumer products is inevitable as the labor market is expected to weaken from today's level as a direct result of the Fed's firm commitment to fight inflation. By year-end 2023 the Fed expects the unemployment rate to be 4.4% from today's 3.5%. This translates into 1.5 million more lost jobs but could be higher if the labor force increases from today's level. Anticipating the road ahead, this article considers how auto loan ABS is well-positioned to weather this shift in consumer credit quality. Given the unique nature of today's macroeconomic environment, we will continue to watch this market closely to monitor shifting dynamics relative to historical norms.

So far in 2022, securitization has funded over $90 billion of auto-related ABS with ABS backed by prime auto loans contributing $38 billion, or 42%, of this total while $27 billion, or 30%, funded subprime borrowers.

Auto loan ABS are backed by retail loans to prime and subprime borrowers. These securities benefit from a structure that allows for a rapid pay-down of the bonds as credit support builds, improving the risk profile of the ABS as the deal ages, and resulting in a stellar ratings performance history. Since 2004, there have been 3120 upgrades and only 15 downgrades, or less than 1%, according to S&P Global. The structure is resilient during periods of market stress, making the highly rated bonds popular in a risk-off market environment.

Auto ABS Issuance 2022 YTD Clears $90bn; 30% Funded Subprime Borrowers



Source: SFA Market Compilation

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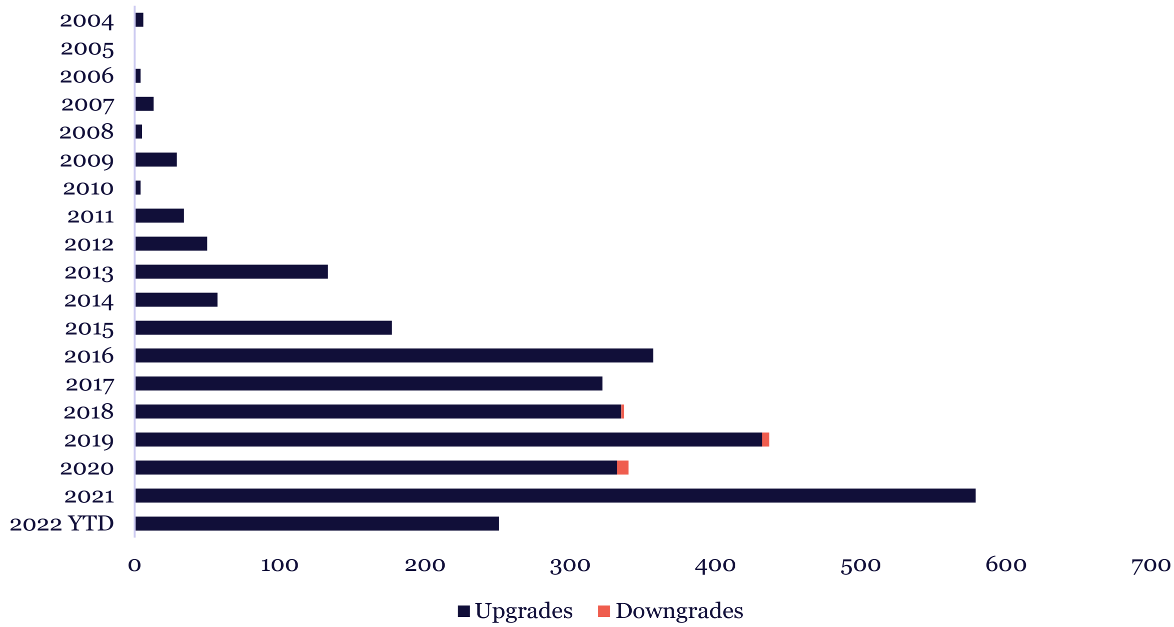
S&P: Less than 1% of Auto ABS Ratings Have Been Downgraded Since 2004 Due to Collateral Performance



Source: S&P Global

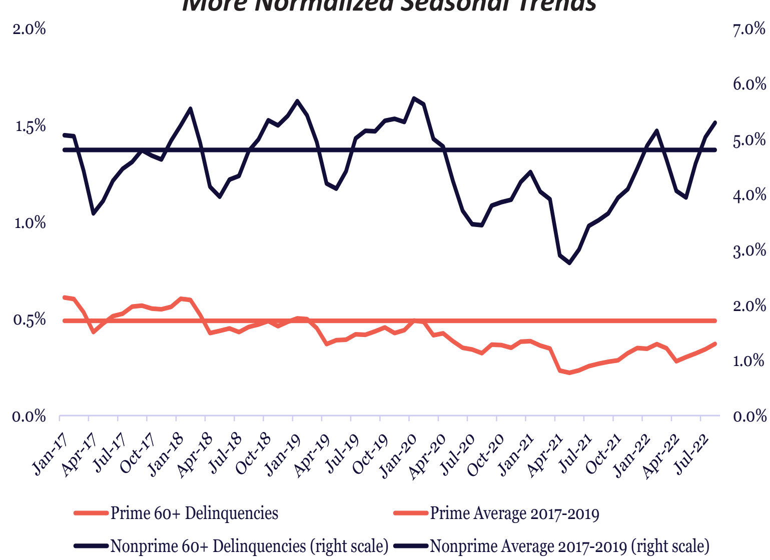
While performance has weakened from 2021 levels, the credit fundamentals for this asset class remain firm for various reasons including the value of the underlying assets, consumer behavior and delinquency rates.

Auto ABS bonds benefit from underlying loans that are secured by a highly valued asset, supporting loan repayments. A 2020 study from Experian reports that borrowers with auto, mortgage, retail and bankcard loans, will typically pay their secured loans first before unsecured loans. This behavior was consistent across multiple observation dates: pre-2008 recession, during 2008 recession, pre-pandemic, during pandemic. We expect this behavior to hold true in today's environment.

Indeed, an October 2022 study from TransUnion reports that despite weakening consumer credit in today's environments, consumers continue to value their auto loans, prioritizing auto payments "well above" credit cards and "just behind" mortgages.

KBRA's Auto Loan Indices for August 2022 shows that the 60+ delinquency rate for auto ABS backed by prime loans is 10 bp higher from one year ago (0.37% vs. 0.27%) while the same metric for nonprime loans is up 177 bp (5.30% vs. 3.53%). Between 2017 and 2019, the delinquency metric for prime auto ABS averaged 0.49%; the nonprime average was 4.80%. KBRA expects performance will return to "more normalized seasonal trends" for the remainder of the year.

KBRA: Auto ABS Performance Expected to Return to "More Normalized Seasonal Trends"



Source: KBRA Auto Loan Indices for August 2022

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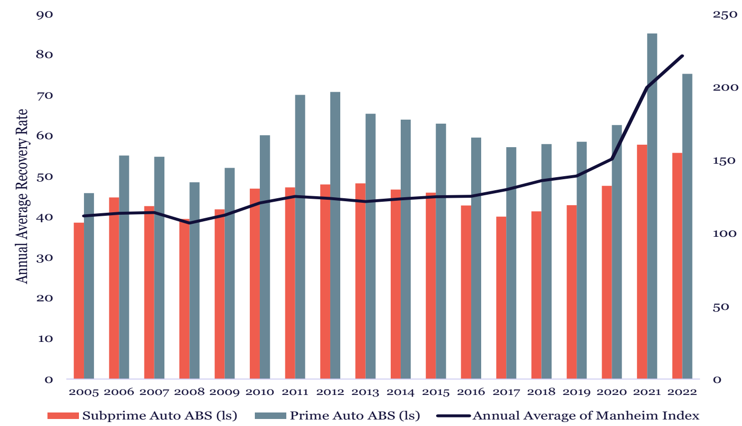
Looking ahead, if the rise in unemployment coincides with a protracted recession, as expected, delinquencies will transition to losses as borrowers default on their loans. The secured nature of auto loans and the still strong used vehicle market, according to the Manheim Used vehicle Value Index, results in higher liquidation proceeds and will limit the severity of auto loan losses. In August, the loss severity rate for prime auto loan ABS was 39%, below the 46% average recorded between 2017 and 2019. For ABS backed by nonprime loans, the severity rate was 52%, compared to a 57% average in the 2017-2019 period, according to KBRA data.

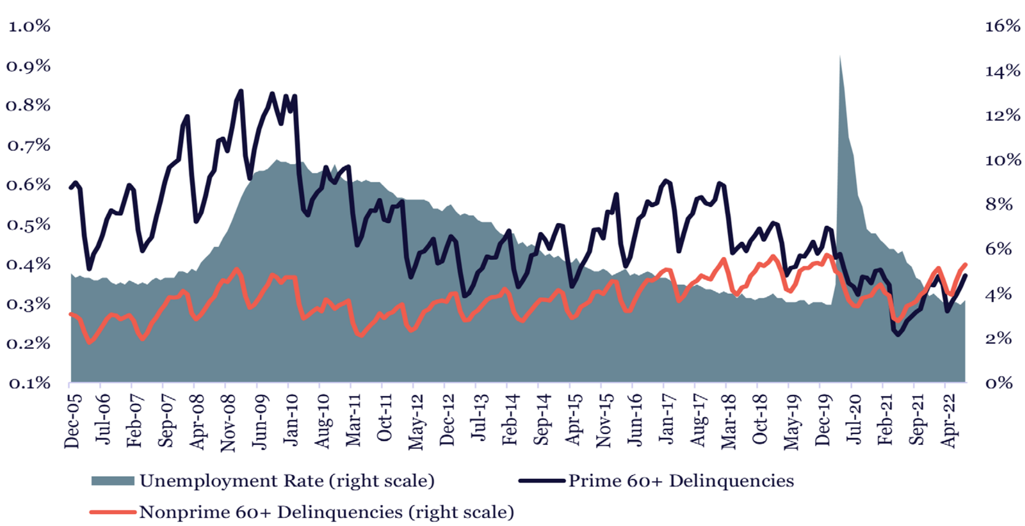
Auto ABS Boosted by Strong Recovery Rates



Source: S&P Global, Manheim Used Vehicle Value Index

Historic consumer behavior appears to be holding true today, delinquency rates are within manageable levels, while the market for the underlying assets remains strong despite rocky inflationary impacts, altogether putting Auto ABS in gear for the challenges ahead.

Auto ABS Performance Tracks Unemployment Rate



Source: KBRA Auto Loan Indices for August 2022, U.S. Bureau of Labor Statistics