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SFA Research Corner

ABS Issuance Soars: SRT Interest Grows, But Cash ABS Remains King

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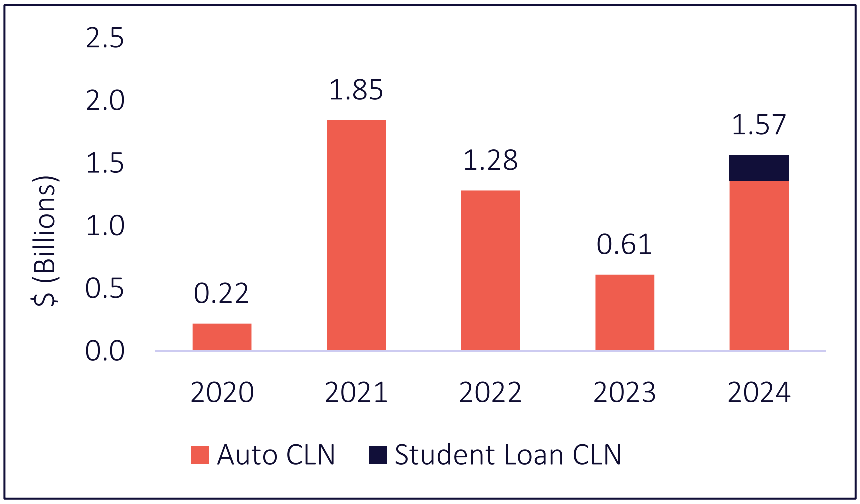
Credit-linked notes (CLNs), a type of synthetic transaction, have contributed $1.6 billion to this year's ABS total and over $5.5 billion since 2020. Notably, over 97% of these CLNs have referenced prime auto loans, which, like mortgages, are ideal candidates for these transfers as their regulatory capital requirements significantly exceed their historical loss performance. SFA explored the economic drivers behind synthetic risk transfers (SRT) in our July 2024 paper.

Synthetic Non-Mortgage Securitizations Issuance to Date



Source: Deutsche Bank Securitization Research

Also referred to as significant risk transfer, credit risk transfer (CRT), synthetic securitization, or synthetic CRT, SRT functions similarly to reinsurance in the insurance industry, enabling institutions to manage capital and risk. Although both industries aim to reduce capital burdens by transferring risk to third parties, the specific mechanisms, types of risk transferred, and regulatory frameworks vary.

In a recent analysis, S&P compared synthetic securitizations with traditional cash securitizations, highlighting five critical areas: counterparty risk, payment structure, operational risk, legal and regulatory risk, and the credit quality of the reference portfolio (the pool of loans that remains on the bank's balance sheet and is referenced by the synthetic transaction). According to S&P's Ronald Burt, "When comparing a synthetic CRT to a traditional securitization having the same underlying portfolio of assets and the same level of hard credit enhancement, we believe there could be material differences in creditworthiness depending on how credit events and recoveries are defined, principal payment mechanics and the presence of any performance triggers, the inclusion of any synthetic excess spread, and the transaction's legal and counterparty risk exposures." Burt added, "As the use of synthetic CRT transactions expands into new jurisdictions and underlying asset types, stakeholders will need to remain alert to these potential differences with traditional securitizations."

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Basel III regulations are likely to impose higher capital charges globally, driving greater use of synthetic securitizations for regulatory capital relief on consumer loan portfolios. However, S&P's Matthew Mitchell noted, "while higher capital charges on the underlying assets could incentivize more use of CRT, such transactions will likely become more challenging and costly, given capital charges may also change on the resulting securitization exposures."

Despite the growing interest in synthetic transactions, traditional cash ABS transactions drive the U.S. market.

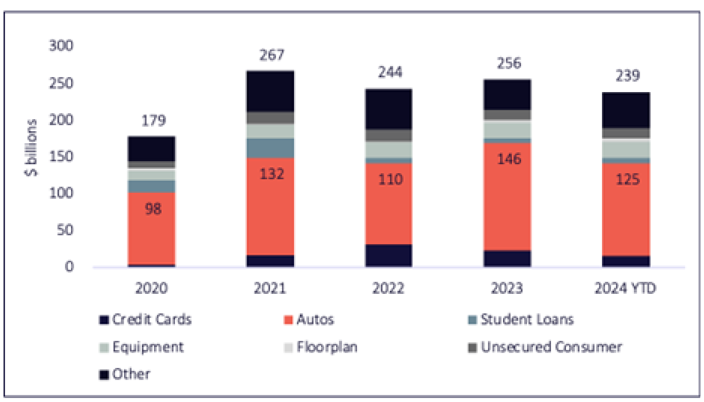
As of September 13, total ABS issuance reached $239 billion, just $17 billion shy of 2023's full-year total, marking a 26% increase from the same time last year, according to JP Morgan's ABS Weekly Volume Datasheet. While the pace of growth has slowed somewhat since July, when supply was up 40% year-over-year, the market remains on track for one of the strongest years in recent history.

Except for the credit card sector, all other ABS categories have posted strong growth. Notably, student loans, driven entirely by private credit, soared 68% year-over-year to $7.2 billion. Additionally, sectors like whole business, cell phone payments, and data centers grew 59% to $49.7 billion, ABS backed by equipment loans and leases saw a 50% increase, reaching $22.4 billion.

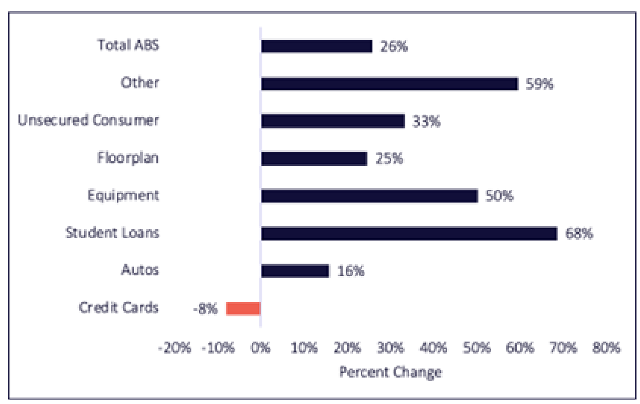
Auto ABS remains the market leader, comprising over 50% of total issuance at $125 billion, with a 16% overall increase. ABS backed by auto leases surged 36%, while deals backed by prime and nonprime loans rose 10% and 18%, respectively.

The surge in supply was smoothly absorbed as demand remained strong. Credit risk spreads tightened slightly against benchmarks, reflecting higher bond prices, steady despite the increased supply.

ABS New Issuance on Track for Record Year...



... With Strong Growth Across ABS, Except for Credit Cards



Source: ABS Weekly Volume Datasheet, JP Morgan Securities