Subprime Auto Lending Exposed to Domino Risk

The US subprime auto lending market is structurally exposed to higher "domino" risk than other asset-backed securities: the larger number of start-ups and increase in competition means financial difficulties at one lender could quickly spread to others.

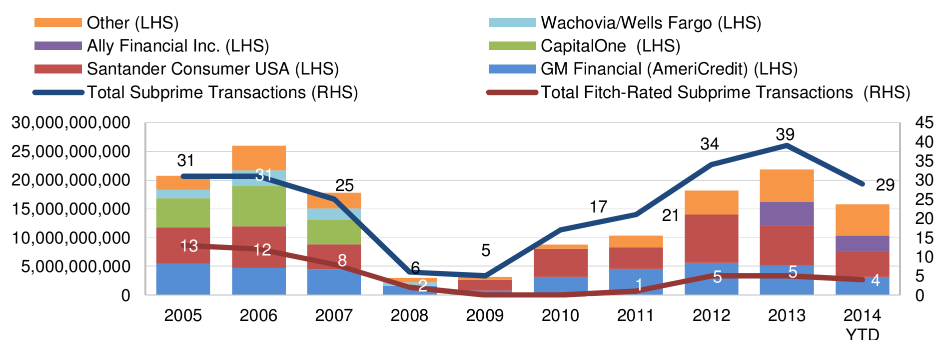
Media reports are comparing the expansion in subprime auto lending to that in the subprime mortgage market in 2006-2007, which precipitated the financial crisis. Direct parallels between the two product types are limited because the market is much smaller, the asset depreciates and automobiles are much less integral to the economy than housing. But the rating and investment approach for subprime auto ABS still calls for caution due to the performance volatility associated with lower-credit-quality borrowers, exposure to potential car dealership misrepresentation and fraud, and dangers posed by a rapid increase in competition among lenders.

Most subprime auto transactions do not warrant high investment-grade (‘AAAsf’ or ‘AAsf’) ratings due to the unique risks involved in this sector and should be capped at ‘Asf’ or lower. Fitch rates transactions from only three of the nearly 20 active US subprime auto ABS issuers: GM Financial (AMCAR), Santander Consumer USA (SDART) and Ally Financial (CARAT).

We have consistently voiced our concerns about observed and anticipated declines in asset quality as lender competition has intensified in the sector. Many auto finance companies also suffer from dependence on securitizations for their funding needs. Both issues could lead to higher rating volatility. Sole reliance on ABS can leave lenders overly exposed to market volatility, which can influence business practices that ultimately affect investors and consumers alike.

Limited financial flexibility and inconsistent or limited historical performance are the most prominent risks separating transactions from issuers we would rate ‘AAAsf’ and those we would not. In some cases we would rate the same transaction but impose an ‘A’ rating cap, while in others we may decline to rate the transaction altogether.

Subprime Auto ABS Issuance Heads Towards 2006 Peak



Source: Fitch, As of August 30, 2014.

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Fact Check

Issuance

Subprime issuance is 23% of total auto loan ABS.

Borrower Quality

More than 30% of the US population has had FICO scores below 649 since 2005. Most collateral pools include weighted average FICO scores below 599 (often well below).

Pools include a high percentage of used vehicles and an increasing number of longer-dated loans.

Performance

Peak losses occurred in 2007.

Cumulative net losses are between 7% and 25+%.

2013-2014 ratings performance: 13 upgrades and no downgrades.

It is imperative that issuers have the ability to handle high loss volatility if their transactions are to achieve 'AAAsf' Fitch ratings. The issuers of the few subprime auto ABS transactions that Fitch rates up to 'AAAsf' have endured significant periods of market stress. They experienced an increase in delinquency and losses during periods of stress, but they also showed the ability to tap alternative forms of financing, significantly curtail lending and provide increased support to their servicing operations. Subprime auto loan losses are vulnerable to large swings even under modest economic stress.

Subprime lenders are facing greater regulatory and legislative scrutiny, which will require them to make substantial investments in their compliance and quality assurance functions. The limited financial flexibility of subprime borrowers means they require a high degree of servicer expertise and consumer interaction to resolve delinquencies as early as possible, particularly given the volatility in 60+ day delinquencies. This can be an expensive endeavor, for which some companies are not fully prepared.

Key Issuer-Related Factors Capping Ratings Below 'AAAsf':

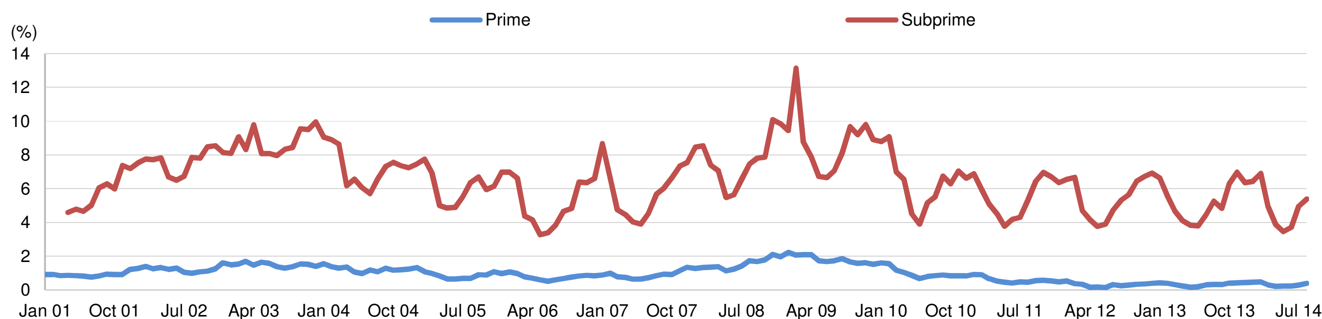
- Limited operating history, lack of full cycle performance
- Limited financial flexibility
- Overreliance on securitization for funding
- Inconsistent underwriting history
- Insufficient dealer oversight procedures
- Untested or lower-quality servicing operations

Origination and Servicing Critical

Origination and servicing quality, and financial stability in subprime auto lending are critical to ensuring that ABS investors are reasonably protected from excessive rating volatility. New start-ups and subprime lenders backed primarily by private equity are particularly vulnerable to the risks and expenses of performance volatility. Start-ups often need to establish toeholds in the market by focusing on lower-credit-quality borrowers or those rejected by other lenders. In addition, private equity investors who are short-term focused may withdraw or limit their financial support if performance declines, expenses increase and profitability drops. Such a combination of performance declines and support withdrawal could significantly affect operations and amplify losses.

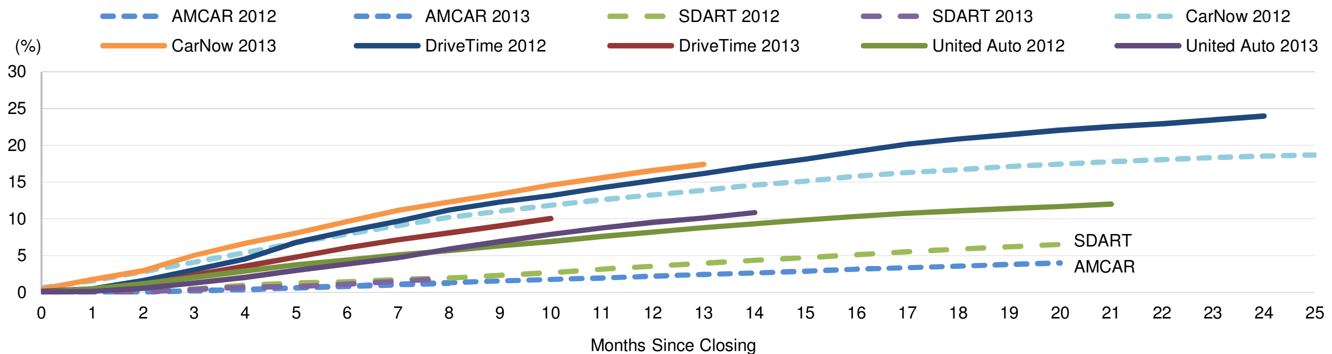
Smaller, less stable lenders may have a greater willingness to deviate from underwriting guidelines to aggressively grow portfolios or maintain loan flow. This, combined with a limited ability to support servicing operations, means losses could accelerate well beyond expectations.

Subprime Annualized Net Losses More Volatile Than Prime



Source: Fitch

Significant CNL Performance Differences Exist in Subprime Auto



Source: Fitch

Negative headlines could result in credit lines being pulled and private equity support withdrawn for several lenders simultaneously. This type of event occurred in subprime auto, equipment leasing and franchise lending in the late 1990s, and in several other asset classes since. It is dangerous to assume that larger lenders would automatically step up and support a wave of consolidation and it is unclear whether some smaller lenders would be left stranded and their borrowers under-serviced. This risk is the key cause of the rating cap Fitch would impose on transactions from many subprime auto loan ABS issuers.

The primary factor mitigating risks to senior subprime auto loan ABS bondholders is the high level of credit enhancement, which is typically via subordination and excess spread. The sequential nature of most transaction structures results in a building of credit enhancement as transactions pay down, assuming losses do not spike shortly after issuance. The relatively short life of the assets, although increasing, previously limited the window in which investors are exposed to issuer-related concerns. These are certainly high on the list of factors Fitch considers when reviewing the transactions in this asset class that it rates. But relying exclusively on credit enhancement to address the many risks in subprime auto ABS could be a risky rating and investment strategy.

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