Insight INVESTMENT

US SUBPRIME AUTO LOANS
SYSTEMIC RISK OR CONTAINED WEAKNESS?

AUGUST 2018

> **US auto loan markets have attracted recent attention due to rising delinquencies. However, we believe there is little potential for systemic risk in the structured credit and private lending markets, and we expect market weakness to be contained.**

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SYSTEMIC RISK OR CONTAINED WEAKNESS?

RISING DELINQUENCIES IN AUTO LENDING MARKETS HAS LED TO A NUMBER OF RECENT HEADLINES. REPORTS OF LOOSENING LENDING STANDARDS HAVE DRAWN COMPARISONS TO THE 2008 US SUBPRIME MORTGAGE CRISIS. HOWEVER, OUR ANALYSIS INDICATES THAT THE ASSET-BACKED SECURITIES (ABS) MARKET WILL REMAIN LARGELY INSULATED AND GIVEN THE RELATIVELY SMALL SIZE OF THE MARKET, THE POTENTIAL FOR SYSTEMIC CONCERNS IS REMOTE. DILIGENT, SKILLED SECURED FINANCE INVESTORS SHOULD BE ABLE TO PINPOINT ATTRACTIVE OPPORTUNITIES WITHIN PUBLIC AND PRIVATE AREAS OF THE MARKET.

The total size of the US auto loan market is $1.1trn, and 84% of the outstanding auto-loan market is prime or near-prime. Of the $179bn subprime auto loan market, a fifth is structured into ABS instruments, with the rest existing as private loans. The market is dwarfed by the $9trn US mortgage market which saw three-quarters of loans structured into ABS prior to the financial crisis.

In evaluating the outlook for auto loans, an area of the public and private secured finance market in which Insight invests, we believe the sector will face some headwinds leading to some consolidation among smaller lenders, but will remain robust overall.

EXAMINING RECENT UNDERPERFORMANCE OF AUTO LOANS

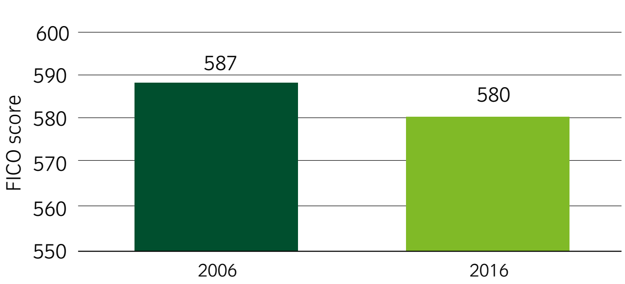
The performance of auto loans, particularly in US subprime markets, has undeniably weakened over the last few years. By some measures, delinquencies have breached global financial crisis highs. Figure 1 shows the rise in 60-day delinquencies and although the data is subject to seasonal peaks and troughs surrounding the tax return period, an overall uptrend appears to be in place.

Figure 1: US auto delinquencies on the rise[1]

[1] Source: Fitch, May 2017.

In our view, reports reflecting a loosening in overall credit standards in the auto loan market are accurate on the whole. We have demonstrated this by looking at the average FICO score (the standard US consumer credit metric) which is roughly seven to ten points lower today than it was in 2006 (Figure 2). Average terms on auto loans have also extended by around 10 months.

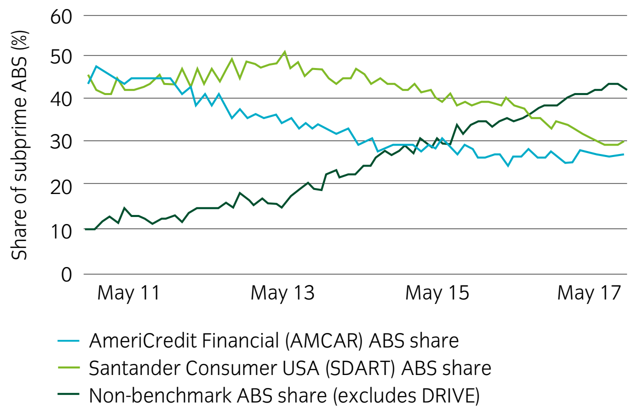
Figure 2: Average US consumer credit score has fallen[2]



However, within the auto market, much of this deterioration is attributable to a certain sector of the market known as 'deep subprime'[1]. Deep subprime loans are often written by non-bank entities such as car dealerships' in-house financing operations. Figure 3 illustrates that the share of deep subprime within the overall subprime auto loan market has grown significantly over the last few years (as represented by the dark green line). The growth in deep subprime correlates strongly with the overall rise in delinquencies demonstrated in Figure 1.

The main lenders in the US subprime auto market are AmeriCredit Financial (AMCAR) and Santander Consumer USA (SDART). Structured deals originated from these entities are considered to be relatively benign in terms of subprime credit risks, with cumulative expected losses in the region of 8%.

Figure 3: The share of 'deep subprime' lending has grown[3]



The non-benchmark ABS share in Figure 3 is the best available proxy for deep subprime issuance. The cumulative losses on this segment of the market are expected to be markedly higher on average than the AMCAR and SDART shelves[4] – closer to 25%.

[2] Source: Prospectuses and Citi Research, as of May 2017. [3] Source: Intex, Wells Fargo Securities, May 2017. [4] Deep subprime bonds are typically secured by loans with materially lower credit quality and feature higher levels of initial credit enhancement and ongoing excess spread.

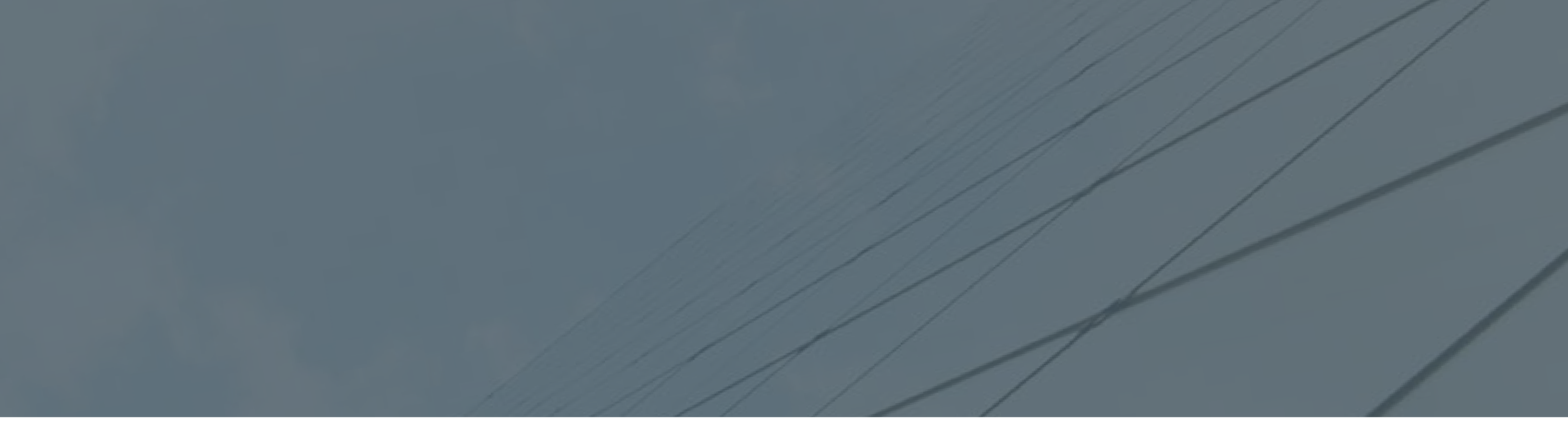
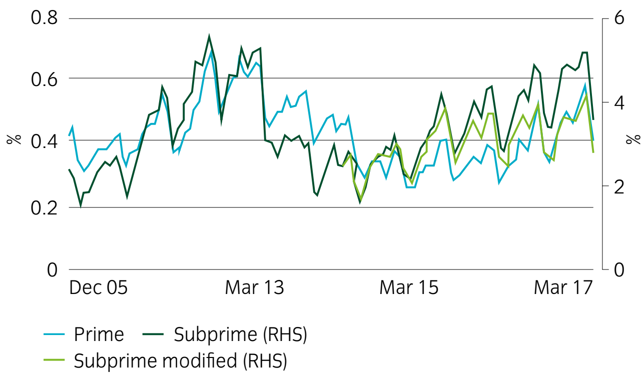


Figure 4 contrasts the 60-day delinquency rates on US auto subprime and a modified version of the US subprime auto data series that excludes three of the major deep subprime issuers.

Figure 4: Subprime delinquencies with deep subprime issuers removed closely resemble trends in prime auto market[5]



> Much of this deterioration is attributable to a certain sector of the market known as 'deep subprime'[6].

The modified subprime series demonstrates a materially gentler uptick in delinquencies over the last few years than the regular subprime series does. Undeniably, it does still show an uptick in delinquencies overall. However, within the modified series, the weakness of the asset class is still significantly lower than pre-crisis levels. The modified series also notably correlates more closely to the pattern of delinquencies in prime auto lending markets. In our view, taking into account the effect of growing deep subprime markets, the recent weakness in the auto loan market is not as severe as headline reports suggest.

COULD FURTHER AUTO LOAN WEAKNESS BECOME A SYSTEMIC ECONOMIC THREAT?

In a worst case scenario, that the current weakness eventually becomes more severe, we believe the risk of market contagion is still very low. Much of the press attention has focused on the fact that auto loan weakness has returned closer to global financial crisis levels. However, even if this were true when excluding deep subprime, it would not necessarily indicate a material deterioration. The subprime auto market did not experience the materiality of downgrades or bond losses as experienced in other areas such as US subprime mortgages during the global financial crisis, as credit enhancement and other structural features protected bondholders.

[5] Source: Standard & Poor's Financial Services LLC, May 2017. [6] A shelf refers to a program of ABS issuance secured against loans of the same type drawn from a larger pool of loans typically originated by the same lender.

Furthermore, while deep subprime auto loans have significantly higher expected losses than regular subprime auto debt, ABS secured against these loans are structured with a greater level of credit enhancement. This means that loan losses are less likely to feed through to ABS investors. Under our base case loss expectations, we still expect the vast majority of subprime auto ABS to pay off as promised.

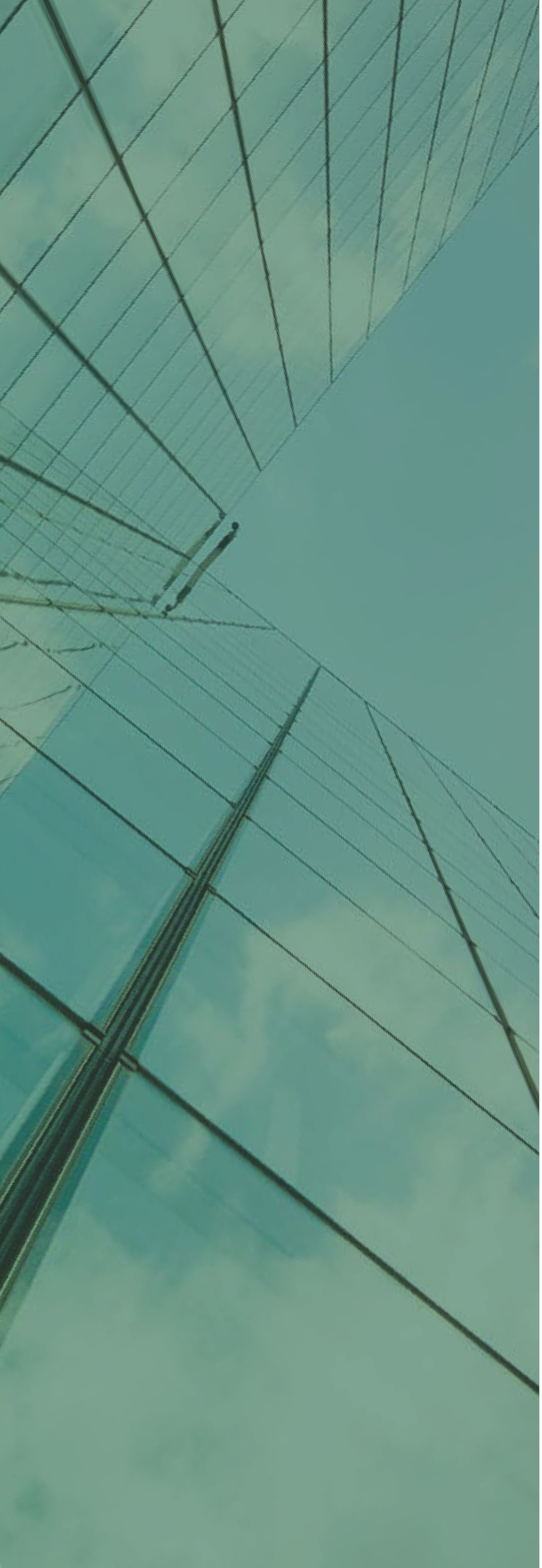
Credit enhancement has demonstrably increased in the subprime market due to the rising proportion of deep subprime. According to Fitch, credit enhancement levels were roughly 36% in 2013 and increased to 44% in 2016. This additional cushion reduces the possibility of a systemic crisis from losses in auto ABS markets.

The relatively small size of the auto loan market makes the possibility of system risks remote. The US auto loan market volume in total is $1.1trn, compared to the $2.8trn of US mortgages issued in 2006 alone. The deep subprime market accounts for only around 10% of this amount. The overall share of subprime in the auto loan market is also lower today than it was during the financial crisis (although of course the deep subprime segment has been increasing in recent years).

This is not to say that some weakness will not occur in the subprime auto market or to lesser extent the prime market. The used car market has come under pressure, according to the NADA Used Car Index (Figure 5). Although it is worth considering that the similar Manheim Index, which better reflects the prevailing mix of vehicles being sold by including a higher proportion of recently-popular SUVs as well as trucks, has not significantly weakened. Furthermore, the economic backdrop is supportive with consumer confidence around post-crisis highs in the US and the unemployment rate reaching a 10-year low in May 2017. However, a source of weakness may be found in the younger demographics that have suffered the most from growing income inequality.

Figure 5: Used car values paint a mixed picture[7]

[7] Source: Barclays, May 2017.



HOW IS WEAKNESS IN THE AUTO LOAN MARKET LIKELY TO PLAY OUT?

Longer term, we expect to see market consolidation across the smaller, non-bank auto lending market. There are over 20 subprime and deep subprime lenders active today. Many of these lenders formed partly as result of a material private equity allocation into the sector in 2010 when the auto market looked oversold and benefited from US government policies. There are a number of smaller players with small management and service teams. A number of these will likely need to consolidate, but we do not envisage significantly more stress within the sector. Given the credit enhancement and other structure features within the Auto ABS market, we expect bondholders will remain well protected.

An Experian report in June 2017 highlighted the continuing deterioration in 60-day delinquencies, and more importantly, the decline in subprime auto loan volumes. The volume of loans written to subprime and deep subprime borrowers fell by 8.6% in the first quarter of this year, a 10-year low. While stricter underwriting standards in the subprime and deep subprime markets should lead to improved performance over time, lower loan volumes will pressure the smaller issuers who need a certain level of scalability to continue being viable. This further highlights the potential requirement for consolidation within the industry.

The subprime auto market did not experience the materiality of downgrades or bond losses as experienced in other areas such as US subprime mortgages during the global financial crisis.

HOW SHOULD INVESTORS POSITION WITHIN THE AUTO LOAN MARKET?

In our view, investors need to understand that issuers in this space are far from monolithic. Some loans are issued via large institutions, others by multi-line consumer finance companies. Insight believes in focusing on either the larger operators that have the appropriate corporate governance in place to ensure discipline, or those that have higher barriers to entry within the industry. Originations from large issuers have fallen substantially in recent quarters, and we view this type of caution as a positive development.

Investors may also wish to consider slowing the pace at which they may roll out of a prior deal and into a newer one. In order to ride the deleveraging upgrade that can typically be seen a year into a deal's life.

Insight also believes on focusing more attention on issuers that place more emphasis on consumer credit over collateral value. We see different philosophies across management teams, some of which look more to loan-to-value ratios whereas others focus on credit circumstances and credit history when lending, which makes them more cognizant of the ability of consumer's credit quality to recover; focusing on a consumer's ability to pay should offer investors more protection during times are market stress.

Finally, if investors have the resources, relationships and capability, we believe they can find value by looking at private market opportunities. As a private lender, investors will receive greater insight into a corporate's financial history and its performance. They can also negotiate bespoke covenant protections and control rights to be able to position deals more defensively in challenging environments.

Above all, investors need to ensure their manager has the experience and expertise to successfully pinpoint bottom-up as well as top-down opportunities within asset-backed markets. They need to have the capabilities to consider variables such as cashflow generation of the assets, credit quality, residual values of the collateral, cash flow timing, interest costs, and detailed evaluations of the originators and servicers.

In our view, we believe that advanced capabilities allow investors to extract valuable complexity premia from the public and private structured credit markets, including investments backed by auto loans.

CONTRIBUTORS

Tristan Teoh
Portfolio Manager
– Secured Finance

Patrick Wacker
Analyst – Secured Finance

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FIND OUT MORE

Insight Investment
200 Park Avenue, 7th Floor
New York, NY 10166
212-527-1800

Call charges may vary by provider.

Institutional Business Development
institutionalna@insightinvestment.com

Consultant Relationship Management
consultantsna@insightinvestment.com

Client Service Management
clientservicena@insightinvestment.com

www.insightinvestment.com

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