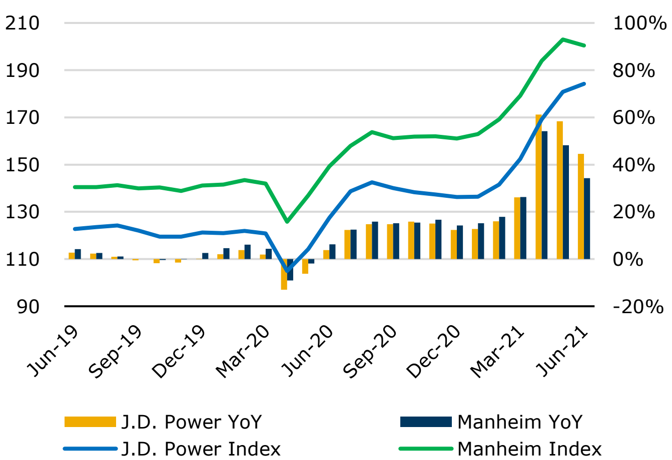
Auto Loan ABS: Grappling With Elevated Used Car Values

A combination of strong demand and stunted supply has led to skyrocketing used vehicle prices in recent months. The sharp rise in prices has benefited auto loan ABS credit performance as higher resale values have boosted recoveries on defaulted loans, contributing to lower net losses across the sector (see KBRA Auto Loan Indices). However, as the economy marches toward a return to pre-pandemic norms, we expect supply and demand imbalances to gradually abate, which may negatively affect recovery rates on future defaults, leading to higher net losses.

Used Vehicle Prices Surge

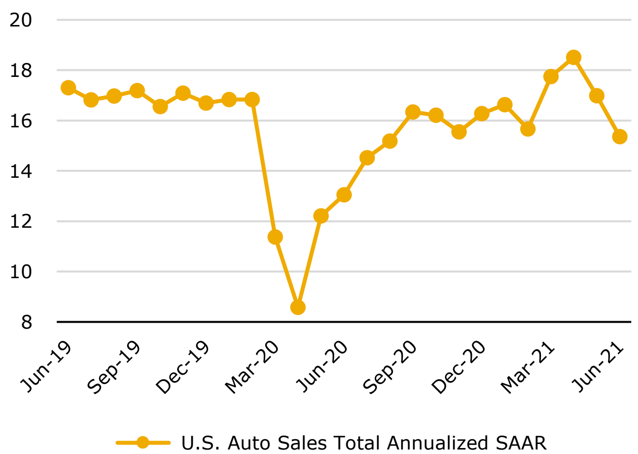
Manheim and J.D. Power—two widely followed wholesale used vehicle price indices—have posted a 40% and 51% increase since February 2020, respectively (see Figure 1). This meteoric rise in used vehicle prices reflects a combination of factors that have simultaneously reduced supply and increased demand. First, new vehicle production fell significantly in 2020 because of manufacturing shutdowns and supply chain disruptions, with the latter continuing to plague manufacturers today (e.g., a shortage of semiconductor chips). Fewer new vehicle sales resulted in fewer trade-ins, which had historically been the largest source of used car supply (see Figure 2). Meanwhile, rental car companies—which are typically a reliable source of used car inventory, as they churn their fleets every few years—significantly de-fleeted in the early months of the pandemic and are now re-fleeting through the used car market to meet increased travel demand. FinDally, demographic shifts and heightened aversion toward public transit, coupled with elevated consumer spending and household incomes from federal stimulus, have helped boost consumer demand.

Figure 1: Used Vehicle Price Indices



Note: Both indices are seasonally adjusted.
Sources: J.D. Power, Manheim, KBRA

Figure 2: U.S. Auto Sales SAARs* (Units/Millions)



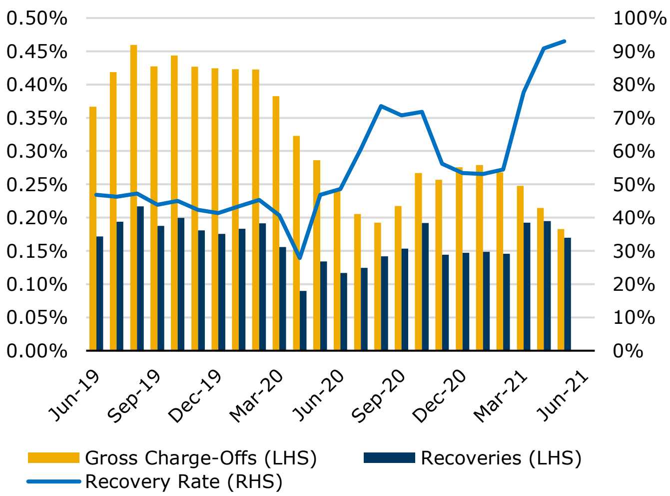
* SAAR = seasonally adjusted annual rate.
Sources: Ward's Automotive Group, KBRA

Limited Credit Performance Benefits

Unsurprisingly, when borrowers default on their loans (and their vehicles are repossessed and sold), higher resale values translate into higher liquidation proceeds. This outcome is playing out in securitized auto loan pools, which have exhibited elevated recovery rates over the past year. Pool-level recovery rates (calculated as the total amount of liquidation proceeds divided by the total principal amount of loans charged-off in each month) reached over 90% in June, which is well above the 40%-50% historical average (see Figure 3).

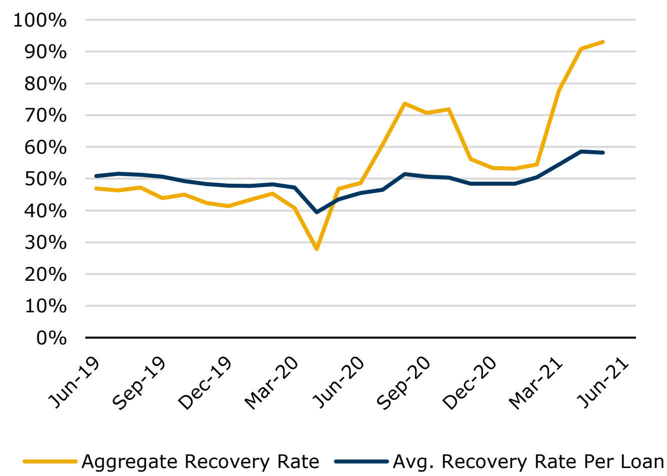
However, elevated auto loan recoveries so far have been heavily influenced by lower charge-off rates in recent months (see Figure 4). This was likely because of an influx of cash to borrowers through tax rebates and a third round of federal stimulus earlier this year, providing borrowers the ability to remain current or satisfy past due payments.

Figure 3: Auto Loan ABS Recovery Rates



Sources: Elicient, KBRA

Figure 4: Comparing Avg. Recovery Rate Per Unit



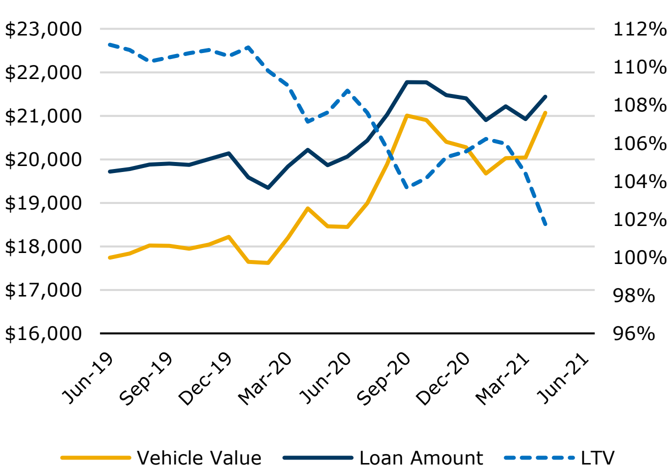
Sources: Elicient, KBRA

Future Implications

Looking forward, if the pandemic-related supply and demand imbalances abate—and used vehicle prices soften—loans originated in today's market will likely experience higher loss severities and net loss rates compared to historical norms. However, to help mitigate this risk, many of the loan originators in KBRA-rated transactions have indicated that valuation-related underwriting criteria, such as loan-to-value (LTV) and debt-to-income (DTI), have been strengthened or maintained amid the rising values. For example, many auto finance companies have maintained the same maximum borrower DTI knock-out rules in their underwriting criteria.[1] If the value of the financed vehicle increases more than the borrower's income, the maximum financed amount will be capped to maintain DTI ratios within required thresholds. If DTI criteria is exceeded, the loan will be declined, or the customer would be offered a less expensive vehicle or require a higher down payment.

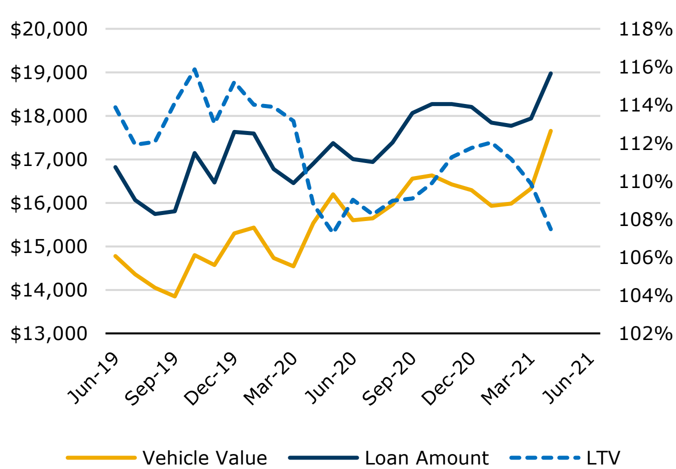
Additionally, many loan originators we interact with have reported increasing the down payment a borrower is required to make, helping to reduce initial LTVs. Only a handful of issuers to date have contributed loans on used vehicles that were originated since prices took off in March, as originators typically warehouse their loans for four to 12 months before they are sold into a securitization trust. However, in their most recent ABS transactions, GM Financial (AMCAR) and Exeter (EART) included loans originated over the past few months. In both cases, average used vehicle values were approximately 20% above pre-pandemic levels, while loan amounts have increased just 10%-15% (see Figure 5 and Figure 6). This indicates that originators in the sector are indeed reducing LTVs to mitigate the risk of a future softening used car market.

Figure 5: AMCAR Used Vehicle Origination Metrics



Sources: Elicient, KBRA

Figure 6: EART Used Vehicle Origination Metrics



Sources: Elicient, KBRA

[1] Total monthly debt payments (including new auto loans) divided by monthly income.

From a ratings perspective, KBRA considers the potential impact of the inflated used vehicle market when formulating its base-case cumulative net loss and recovery rates by reviewing historical performance data. Despite observing higher recovery rates in more recent static pool vintages, we have generally assumed lower net recovery rates, as these trends are unlikely to be sustainable once supply and demand normalize.

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