Closer Look at Credit Enhancements in Subprime Auto ABS Market Show Signs of Vulnerability

New "Credit Chronometer" to Analyze Developments Impacting Credit Markets, including $100 Billion Auto Loan Securitization Market

Davis+Gilbert partner Joseph Cioffi, a widely-respected authority on loan and securitization markets, has found that credit enhancements supporting subprime auto asset-backed securities (ABS) do not necessarily provide the same level of protection as credit enhancements supporting pre-financial crisis era subprime residential mortgage-backed securities (RMBS), leaving them more vulnerable to market shifts and shocks than many realize.

These observations were made on a newly launched blog, the Credit Chronometer, in which Mr. Cioffi and team will be analyzing economic, market and political events that shape the legal landscape, and impact loan and structured credit markets, including those for auto loans, marketplace lending (peer-to-peer), student loans, mortgage loans and Property Assessed Clean Energy (PACE) financing.

In a blog post, Mr. Cioffi noted that the subprime mortgage collapse left clues for the future of subprime auto ABS. "Credit enhancements in those deals could not always fully absorb losses from the real estate crash and its impact on loan performance and recoveries," said Mr. Cioffi. "Subprime auto ABS makes no such mistake regarding vehicles, but the corollary to the assumption of never ending real estate appreciation may be the presumed continued performance by auto loan borrowers." Mr. Cioffi has a warning for those who structure deals with too heavy a reliance on excess spread. "There are a number of hazard signs on this front, including easier credit as a result of softness in the auto sales market, growing household debt and now, a new potential disruptor, climate change."

For more than a decade, Mr. Cioffi has advised on matters relating to cyclical events in subprime lending markets, including extensive involvement in litigation relating to the issuance of RMBS. Now, he sees the potential for trouble in the subprime auto market and the need for close monitoring of practices and factors affecting the market.

Based on the indicators of crisis that foretold the subprime mortgage crisis – within the areas of lending practices, ABS practices and the underlying market for autos – the Credit Chronometer presents the "Subprime Auto Loan Crisis Chronometer" to depict the risk of a crisis, which Mr. Cioffi defines as a "battle over loss allocation." As events impact the subprime auto market, the Subprime Auto Loan Crisis Chronometer's bright yellow gauges will show the current level of risk. As of today, the Subprime Auto Loan Crisis Chronometer is set at:

- Lending practices: Moderate-High
- ABS Practices: Moderate
- Auto Market: High
- Risk of Loss Allocation Battles: Moderate

To avoid a subprime auto crisis, Mr. Cioffi urges, “investors should recognize that relative to subprime RMBS, overcollateralization rates are not exceedingly high, given the equity cushion that was assumed to have existed in homes backing RMBS. Although investors have demanded credit enhancements that correlate to pool risk, a combination of loose lending and rising negative equity creates the prospect that risk allocation battles are on the horizon,” said Mr. Cioffi.

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