Same as ever?

Davis+Gilbert partner Joseph Cioffi reflects on the performance of the US subprime auto sector in 2021 and expectations for 2022

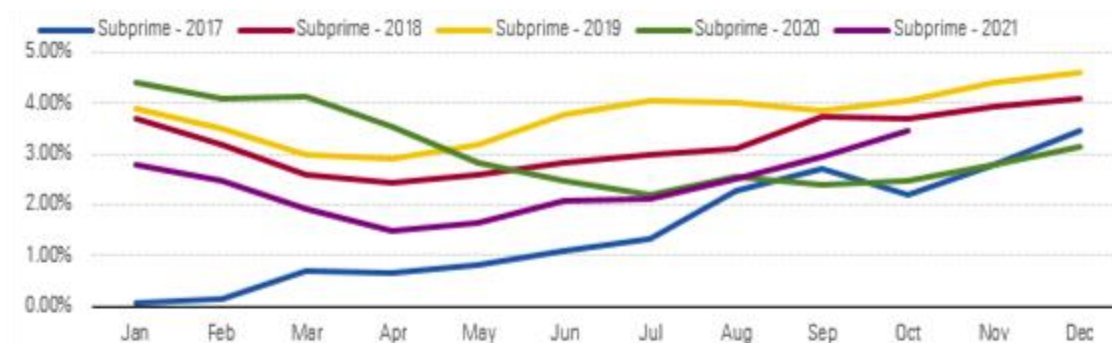
The pandemic has been a surprising boon to the subprime auto ABS market, due to supply issues that have raised collateral values and a potent mix of government support and private actions that have bridged consumers through financial distress. The pandemic's persistence is now calling into question how long favourable conditions may continue and what normalisation will look like. If asked to predict 2022, even Nostradamus would have to shrug.

Nevertheless, the New Year is the time to reflect on 2021 performance and share expectations for the future. In June of 2021, the Davis+Gilbert Credit Chronometer annual subprime auto market study revealed industry participants were at once optimistic and keenly aware of shifting ground. In advance of the next market study to be conducted in summer 2022, below is a look at the 2021 study's results versus actual performance and initial expectations for 2022.

Loan performance
When asked about loan performance, 73% of participants in the 2021 market survey expected some deterioration. This held true in reality in 2021, but only modestly, as there was a gradual shift back to normality.

Credit extensions worked as the first line of defense through 2020. Borrowers rolled off of them through 2021. The end of extensions and government stimulus later in the year resulted in a gradual creep up in delinquencies.

Subprime 60+ DQ



Source: DBRS Morningstar

According to data provided by DBRS Morningstar, subprime 60-plus day delinquencies peaked initially at 2.78% in January 2021, declining to a low of 1.49% in April before reaching a new peak of 3.46% in October. Despite the rise, year-over-year, delinquencies remain below pre-pandemic

levels. ABS losses have been mitigated by soaring vehicle values, but this has the contrasting negative affect of increasing consumers' financial burden and the risk of default.

In 2022, supply chain woes won't be resolved overnight, so "they may continue to benefit deals through the better part of the year," advises Clayton Triick, senior portfolio manager at Angel Oak Capital Advisors. Triick also notes areas to watch are "inflation, high purchase costs, larger loans and a winter wave of new Covid cases, which could mean a rocky start to 2022 before things settle down."

Credit ratings

Our 2021 survey saw participants less concerned about ratings downgrades than the previous year, but still nearly 70% of participants expected downgrades to occur. The major fear at the time was delinquencies, but these concerns have yet to be realised and downgrades have not occurred to the extent anticipated.

According to Ines Beato, svp at DBRS Morningstar, DBRS upgraded or confirmed all but six subordinated classes during the pandemic. Initially, DBRS placed six subordinated classes from six ABS transactions "under review with negative implications" in July 2020, due to potentially insufficient credit enhancement to support the ratings. Since then, the rating agency has upgraded or confirmed the ratings and removed the 'under review' as the transactions deleveraged with pool amortisation over time and credit enhancements increased.

In 2022, key factors for ratings will be continued strength in performance and collateral values. Here's where the end of supply shortages can have an uncertain effect. If prices begin to slip, higher LTVs on outstanding loans could pinch borrowers' ability to trade, making loan payments an even higher priority or - if borrowers are upside down on vehicles bought at the height of the market - they may move on to less expensive vehicles (with less equity in the trade, creating risks on new loans).

Credit enhancements

In 2021, 74% of survey participants expected credit enhancements to increase to support desired ratings. In reality, the vision of higher enhancements generally didn't materialize, given strong performance and collateral values.

DBRS Morningstar reported that for auto loan ABS rated through the pandemic "[c]redit enhancement increased on most auto ABS deals to cover higher loss assumptions on the securitised pools….[But] as performance has stabilised and expectations of higher risks have tapered, loss assumptions and credit enhancement levels have adjusted back to lower levels."

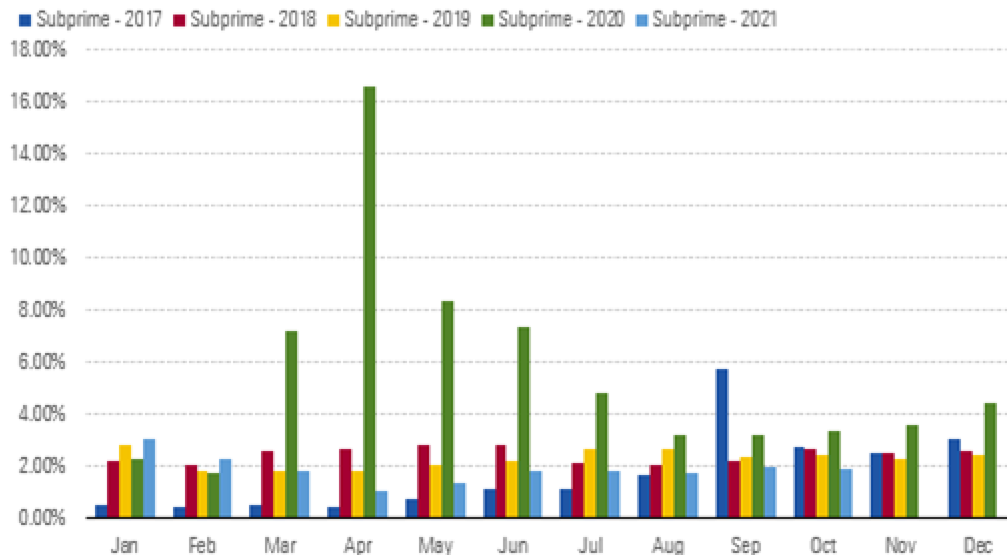
For 2022, as Triick notes, "the normalisation of collateral values is inevitable and it's just a matter of when in 2022, which will impact potential recoveries."

Credit quality and credit extensions

In our 2021 survey, credit quality was not cited as a significant concern, likely due to the prevalence and success of credit extensions. 86% of servicers surveyed expected to grant the same or more extensions over the next 12-24 months. Extensions have played a significant role in the market's positive performance.

Data shows that extensions which spiked during the early pandemic in April and May 2020 have returned to below pre-pandemic levels now. DBRS notes that the 2020 vintage has performed better than the 2018 and 2019 vintages, with its tighter underwriting and the benefit of additional cash thanks to government support.

Extension by vintage (subprime)



Source: DBRS Morningstar

Prudent use of extensions has been an effective tool to address these short-term (or even extended) periods of consumer financial strife. But excessive use of extensions or servicers who are outliers in their use of extensions will be scrutinised. Sean Morgan, svp of finance at Westlake Financial notes: “As the market normalises, extensions simply revert back to an important tool to assist borrowers with micro life events, as opposed to global macro events.”

Regulatory risk

67% of survey participants in our 2021 survey viewed regulatory uncertainty as a major concern.

In 2021, there was some action by the CFPB in auto lending, including civil penalties against Santander for violating the Fair Credit Reporting Act. CFPB studies related to disparities in interest rates suggest it is keeping an eye on the market, but enforcement may have been slowed by director Rohit Chopra’s delayed ascension, as well as the positive performance of auto loans.

Perhaps most significantly for 2022, the CFPB has made effective new debt collection rules under the Fair Debt Collection Act, under Regulation F. The rules focus on communications and disclosures permitted and not for debt collection.

Collectors will need to tread carefully with this new regulatory landscape. “Regulation F could be a positive catalyst for some servicers to rethink their collection strategies and approach to oversight of third-party collectors to reduce the risk of running afoul of laws and improve the borrower’s experience,” suggests Morgan. “It will also advance the debt collection market to more technology-based collection practices.”

Conclusion

Predicting the trajectory of market factors becomes more difficult as the market moves further through the pandemic, given the accumulative effect of events already transpired and the potential for unexpected shocks in the system. The pandemic has created new market forces and realities, but success will still depend on the fundamentals of performance and collateral values – the same as it ever was.

Nicole Serratore, an attorney at Davis+Gilbert LLP, contributed to this article.

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