Shifting Gears: The Acceleration of Prime Auto Securitization

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Asset-backed securities ("ABS") collateralized by prime auto loans are a major component of the ABS market. The auto ABS subsector, which includes both prime and subprime auto loan securitizations, is consistently the largest contributor to new annual ABS supply. To illustrate, in 2023 over $146 billion of auto loan paper was securitized, accounting for more than 57% of the total $256 billon ABS new issue volume.[1]

Over the last year, we've observed a marked increase in the number of banks and credit unions opting to securitize portions of their prime auto loan portfolios. We attribute this trend to rising interest rates which reduces the "stickiness" of retail deposits, and recent regulatory changes affecting both types of institutions. This has been the catalyst for their increased appetite for securitization. The incentives driving these financial institutions to securitize prime auto loans differ greatly from those of traditional OEM captive auto finance companies.

MetLife Investment Management

Banks

In July last year, key bank regulators, including the Federal Reserve, the FDIC and the Comptroller of the Currency, proposed measures aimed at bolstering the "strength and resilience of the banking system".[2] The proposal would modify large bank capital requirements in order to implement the final components of the Basel III agreement (an international regulatory framework governing capital adequacy, stress testing and liquidity requirements for banks). If enacted, the proposal would impose additional capital requirements for banks with assets of $100 billion or more. The net impact of the proposal in its current form makes holding prime auto loans relatively less attractive than other consumer loans (for example, subprime auto loans) from a regulatory capital efficiency perspective.

Fed Chairman Jerome Powell hinted at potential "broad and material changes" to the proposal during his early March address to the House Financial Services Committee. Despite this, we believe major banks have already initiated preparations for its enforcement. They have assessed the efficiency of retaining substantial prime auto loans as portfolio assets under the new regulation and generally determined these asset were not an efficient us of their capital under the new rules. Since there are over $530 billion of auto loans on bank balance sheets according to the FDIC[3] and Moody's estimates that less than 1% has been securitized[4], to optimize regulatory capital efficiency, large banks are incented to reduce their prime auto loan exposures.

Rising funding costs provide banks with another incentive to divest their prime auto holdings. For the last several years, banks have enjoyed a stable retail deposit base due to the low interest rates maintained by the Fed. However, the recent downfall of Silicon Valley Bank illustrates that, in the current environment of higher rates, the stability of deposit funding can no longer be assumed. Diversification of funding sources is a prudent path to pursue and monetizing portfolio holdings is one way that banks can raise capital.

Banks employ three primary strategies to monetize their prime auto loan holdings or mitigate associated risks. The first, and most straightforward, is the direct sale of these assets. While this approach swiftly reduces holdings, it can potentially result in mark-to-market losses, particularly as most of these loans were originated in a lower interest rate environment. This risk of significant losses serves as a substantial deterrent for outright portfolio loans sales.

The second strategy involves traditional securitization of loan assets. This approach has been adopted by several banks, leading to an increase in bank-sponsored prime auto ABS transactions. Depending on pricing spreads, securitization can achieve better overall economics than a direct loan sale, even after accounting for transaction fees. However, this method will impact the sponsoring bank's gain/loss accounting if they divest all the risk assets, which is necessary to gain capital relief.

The third alternative is the sale of Credit Linked Notes (CLNs), a 'synthetic' securitization strategy. In CLN transactions, the assets remain on the bank's balance sheet while their credit risk is transferred to third parties. This approach avoids recognizing losses on the sale of the portfolio assets and offers the issuing bank more control over the transaction and flexibility to target specific risk profiles. However, Fed regulations limit the amount of CLNs any individual bank can issue to $20 billion of notional exposure.

As active ABS market participants, MIM has observed a rise in bank-sponsored prime auto securitizations. This trend is beneficial as it provides us with greater access to these asset pools, enabling us to source attractive securities for our client portfolios more effectively and to enhance portfolio diversification. Currently, the demand for prime auto ABS tranches remains strong, and we haven't identified any significant spread weakness attributed to the increased volume of bank-sponsored prime auto ABS deals. We are mindful of some of the drawbacks of CLNs for investors compared to traditional securitizations. These include increased counterparty exposure to the sponsor, pro-rata structures that do not build credit enhancement over time, and generally worse trading liquidity.

Credit Unions

We've also noticed a rise in prime auto securitizations sponsored by credit unions. Unlike traditional banks, credit unions are non-profit, tax-exempt entities owned and managed by their members. To retain their tax-exempt status, they serve specific population segments, such as labor unions, church groups, or specific professions. The National Credit Union Administration ("NCUA") regulates federally chartered credit unions and provides deposit insurance similar to the FDIC'c coverage for bank customers. State chartered credit unions are overseen by their respective state's financial regulator and may or may not be required to have deposit insurance. Typically, these state chartered credit unions secure deposit insurance from the NCUA, provided they meet certain eligibility criteria.

The NCUA finalized a securitization 'safe harbor' rule in June 2017, enabling credit unions to incorporate securitization into their business operations. This development was marked by the issuance of the first securitized credit union debt by GTE Federal Credit Union in 2019, which was a prime auto deal. Since then, the frequency of prime auto securitizations by various credit unions has seen a dramatic increase.

The primary motivation behind this trend is the aim to diversify their funding sources, moving away from their conventional reliance on retail membership deposits. The current environment of rising interest rates has escalated the cost of deposit financing, thereby acting as a major catalyst for the surge in credit union securitization activities.

Furthermore, the emerging Basel III regulatory framework has made prime auto loans less appealing for banks to originate. This presents an opportunity for credit unions to broaden their business scope, with securitization serving as an efficient financing method for this expansion.

In Summary

We view the entry of credit unions into the securitization sponsor space as a positive development, similar to our perspective on bank-sponsored prime auto volumes. This development broadens the investment opportunities for our client portfolios and enhances portfolio diversification.

However, we remain aware of the potential risks associated with new sponsors. Our ABS credit research team performs thorough due diligence on all the credit union prime auto securitizations we engage in. This involves assessing the strengths and weaknesses of the credit union sponsoring the deal. Generally, we favor larger institutions regulated by the NCUA as deal sponsors.

We also recognize the unique risks associated with credit union auto deals. For instance, the sponsor's membership limitations may lead to a geographically concentrated portfolio and typically longer loan terms compared to deals sponsored by traditional OEM captive finance companies. Moreover, these deals often exhibit worse trading liquidity than benchmark prime auto offerings.

Despite these considerations, we believe the incremental spread provided by credit union deals compared to traditional prime auto securitizations adequately compensates for the increased risks.

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Endnotes:

[1] Source: JP Morgan Chase research

[2] Federal Reserve Board—Agencies request comment on proposed rules to strengthen capital requirements for large banks

[3] https://www.fdic.gov/analysis/quarterly-banking-profile/index.html

[4] Moody's Investors Service, March 14, 2024 Auto ABS—US, Sector in Depth Report

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