Allspring

Expect a Few Bumps, but No Accidents, in Auto ABS

+ Asset-backed securities (ABS) may provide an attractive yield advantage and capital preservation through structural protection.
+ Consumer fundamentals are normalizing from record levels and remain supportive. Consumers' priority of payments aligns with our preference for auto collateral.
+ Credit due diligence is multi-level, with a comprehensive understanding and stress testing at the collateral, loan, and transaction levels. Stress testing over a full economic cycle, including recessionary shocks, is crucial to capturing the full income and return potential of a security.

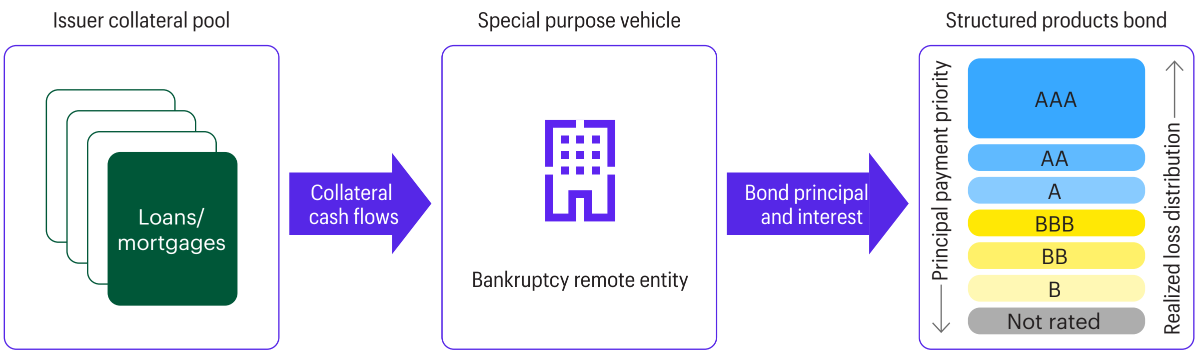
BY ALLSPRING GLOBAL LIQUIDITY SOLUTIONS TEAM

The consumer ABS sector is a compelling asset class for investors within the investment-grade fixed income market: It can provide an attractive yield advantage and capital preservation through structural protection. The sector has been resilient through multiple market cycles and is fully expected to do so again should the cycle turn negative. In the current market environment, ABS yields are attractive and investors should be well served to take advantage of the opportunities.

What are asset-backed securities?

ABS are structured debt obligations backed by a receivable. A typical ABS bond is backed (collateralized) by auto loans or leases, credit card debt, or other types of payment streams that are pooled together into a bankruptcy-remote trust. Each time a primary market syndicate has a new offering, a new trust is created.[1] Due to structural protections provided by the trust, the risks are quantifiable and, thus, ABS securities are less susceptible to idiosyncratic risks. Return of principal and realization of losses from the collateral pool are distributed across tranches, according to the predetermined cash-flow waterfall. The highest-rated tranches are supported by the subordinate tranches, receiving principal payments first and realizing losses last (Figure 1). The focus of this paper is on securities collateralized by auto-related receivables, which in recent years have been the largest collateral type issued, comprising nearly 50% of all issuance.

FIGURE 1



Source: Allspring

1. Securities collateralized by credit card and cell phone payments are issued out of a singular master trust, while deals backed by all other collateral types use a new, unique trust per primary market transaction.

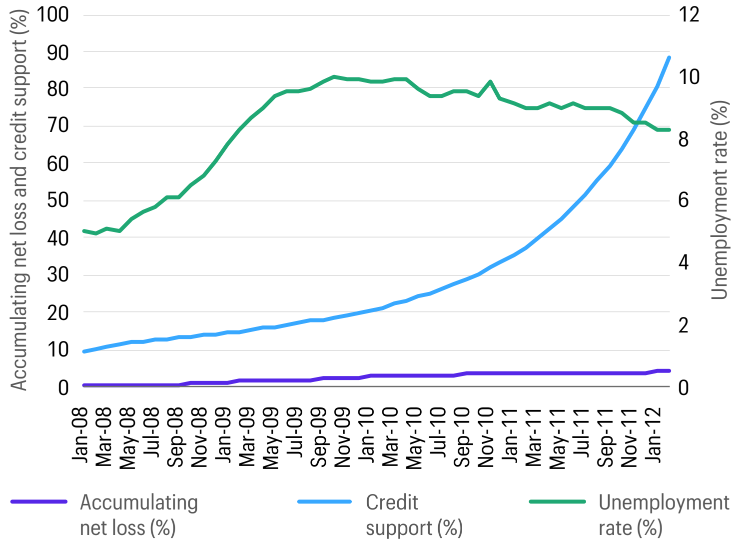
Robust structural protections

When determining the characteristics of auto ABS, the parties involved (investment bankers, rating agencies, and issuers) will determine an expected cumulative net loss percentage (CNL%) based on the characteristics of the borrowing pool and historical performance, among other factors. Once the CNL% is determined, the parties create a structure designed to avoid principal losses under a stressed economic scenario where collateral prices decline by multiples of the expected loss. That additional credit protection is the key reason that higher- than-expected collateral losses should not necessarily affect the performance of the securities themselves. Nearly all auto loan ABS use a senior/subordinate structure for credit enhancement, in addition to overcollateralization and a reserve account. This type of senior/subordinate structure allows for a senior tranche to be rated as high as AAA by the rating agencies.

Securities backed by automobile collateral are amortizing securities; each month, a portion of the payment is used to pay down principal. This allows credit protection to increase over the life of the transaction and is known as a credit enhancement. Figure 2 (above right) is a graph of a CarMax transaction that was issued at the beginning of the 2008 recession when unemployment would ultimately rise to the highest level in nearly three decades.

The Class A notes had an initial credit enhancement of 9.26% compared to an expected CNL% of 2.75%. Even though the transaction's collateral pool experienced a CNL% of 3.94%—above the expected 2.75%—the credit enhancement grew to 88.5%. This increase ensured the Class A notes maintained their Aaa rating and allowed both the subordinate Class B and Class C notes to be upgraded to Aaa from A1 and Baa3, respectively.

FIGURE 2: CARMAX 2008—CLASS A CREDIT ENHANCEMENT % AND ACCUMULATING NET LOSS % VS. UNEMPLOYMENT RATE %



Source: Bureau of Labor Statistics. Data presented from January 15, 2008, through February 15, 2012.

Stable credit ratings with upgrades likely

Historically, the investment-grade structured bond universe has experienced very few defaults and downgrades as a percentage of issuance. This is primarily due to the structural protections and the collateralized nature of the bonds. Of equal importance is the frequency of upgrades; according to data from Moody's from 2009 (Figure 3) to 2022, 88.57% of securities issued as AA-rated were upgraded to AAA by the time they matured from 2009 to 2022. Anecdotally, auto-related collateral is more frequently upgraded than other collateral types, because the securities benefit from de-levering as senior tranches pay down and credit support increases across the entire structure. Improving credit metrics make the securities a frequent candidate for an upgrade.

FIGURE 3: AUTO LIFE-TO-DATE RATING TRANSITIONS BEFORE MATURITY, 2009–2022

U.S. ABS—auto loan									
	INITIAL COUNTS	Aaa	Aa	A	Baa	Ba	B	Caa-C	IMPAIRMENT
Aaa	1,573	100.00%	–	–	–	–	–	–	–
AA	551	88.57%	11.43%	–	–	–	–	–	–
A	296	73.99%	11.15%	14.86%	–	–	–	–	–
BAA	290	69.31%	8.62%	5.52%	16.55%	–	–	–	–
BA	90	48.89%	22.22%	6.67%	7.78%	14.44%	–	–	–
B	42	4.76%	16.67%	9.52%	21.43%	9.52%	38.10%	–	–
CAA-C	–	–	–	–	–	–	–	–	–

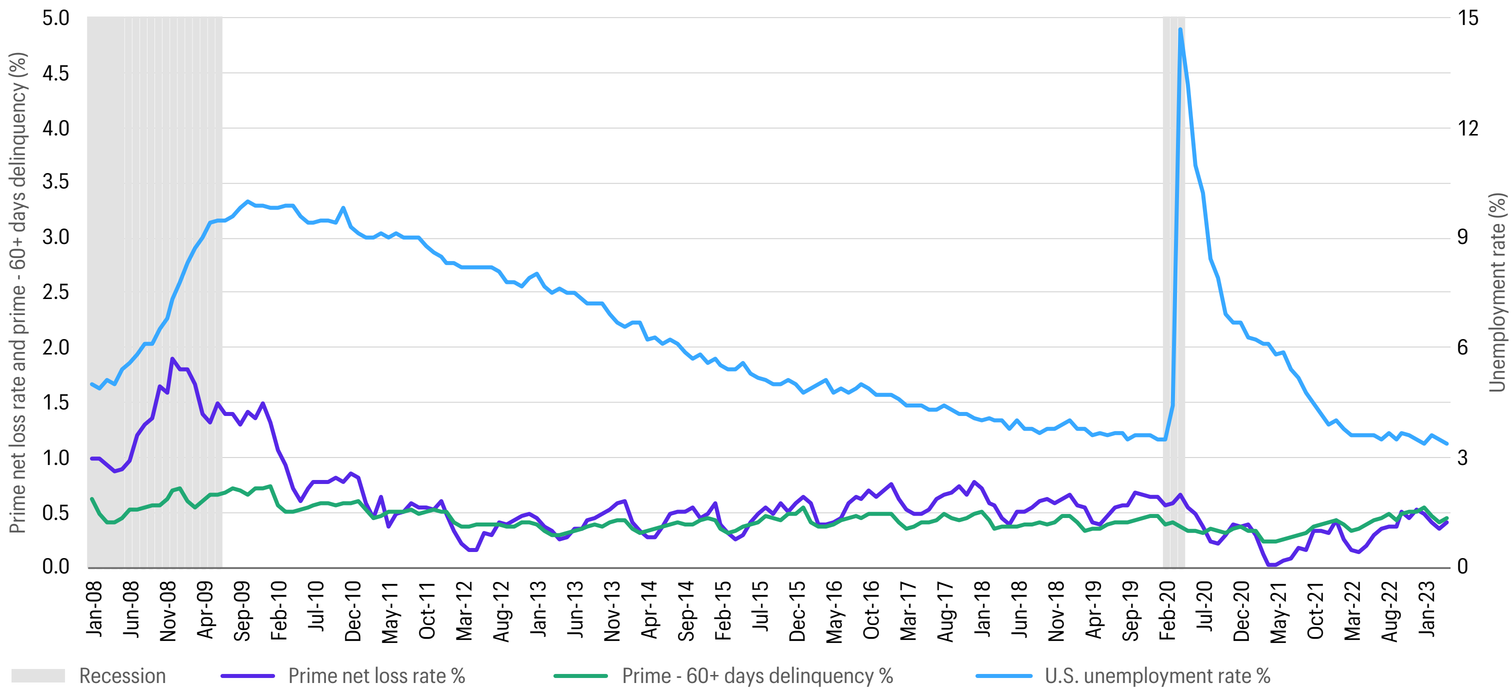
Source: Moody's. Data presented from 2009 through 2022.

Consumer fundamentals are normalizing ...

Consumer fundamentals are normalizing from the record levels witnessed during the pandemic, when the consumer had record-high cash balances, partially due to stimulus money. Since then, household fundamentals have remained supportive due to strong employment and wage gains. However, even in periods of rising unemployment, delinquencies and net losses only saw moderate deterioration (Figure 4).

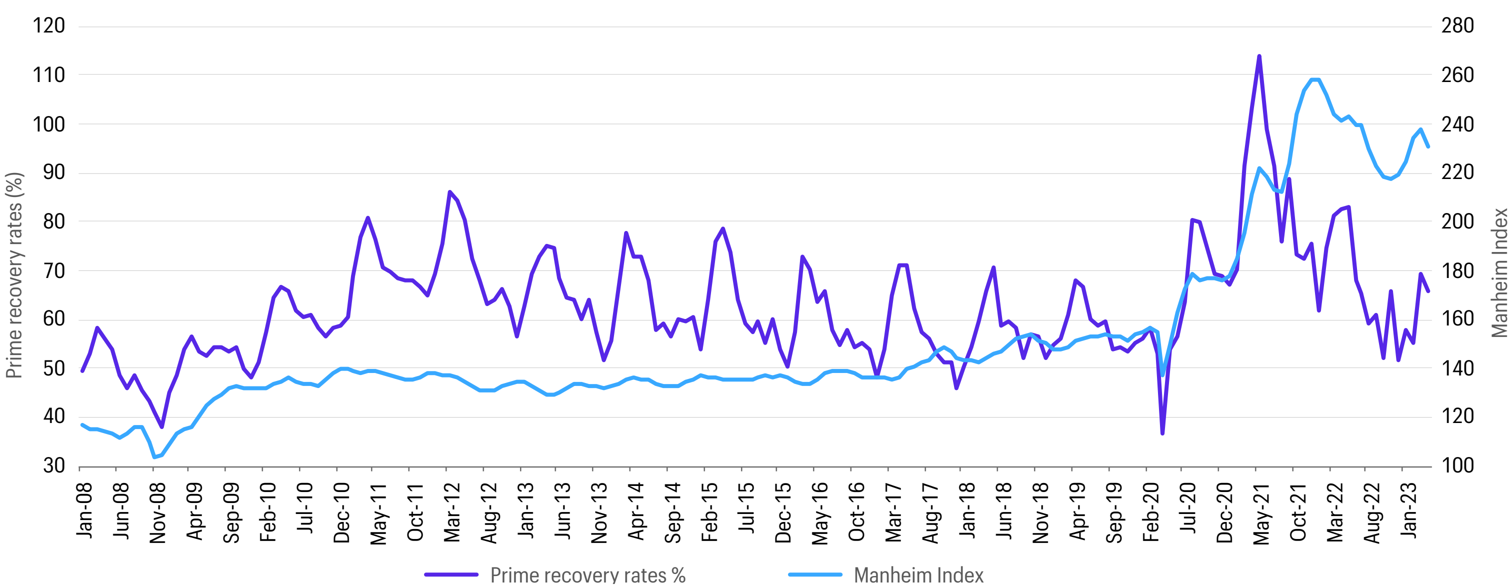
Used car prices, as measured by the Manheim Used Vehicle Value Index, have declined recently but remain above pre-pandemic levels, keeping recovery rates elevated (Figure 5). New car production continues to be historically low, buoying prices. Underwriting standards by lenders have been consistent, if not improving.

FIGURE 4: S&P PRIME AUTO INDEX—NET LOSS % AND DELINQUENCY % VS. U.S. UNEMPLOYMENT RATE



Sources: S&P Global Ratings, Bureau of Labor Statistics, and Bloomberg. Data presented from January 2008 through March 2023. The prime net loss rate is the percentage of outstanding debt that is unlikely to be repaid by prime borrowers.

FIGURE 5: PRIME AUTO RECOVERIES VS. MANHEIM INDEX



Sources: S&P Global Ratings and Manheim Auctions. Data presented from January 2008 through March 2023. The prime recovery rate is the amount of gross charge-offs of prime debt that is eventually repaid.

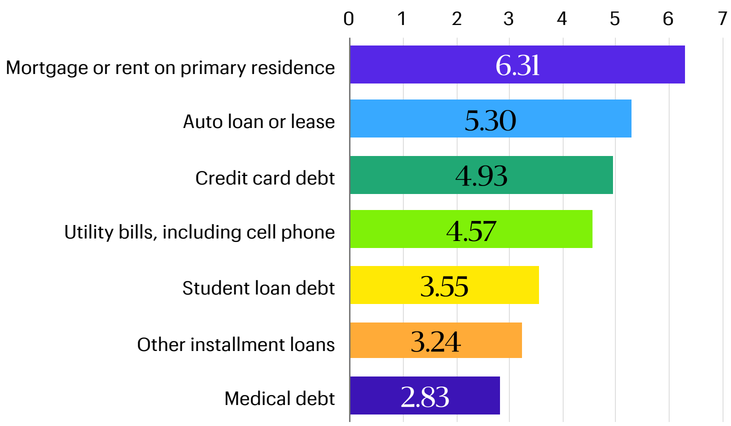
... so debt prioritizations matters

We are cognizant that a strained economic backdrop remains a possibility. In that instance, auto ABS is afforded yet another protection: debt prioritization. A survey of consumers published by Bank of America Global Research (Figure 6) showed that respondents rank their auto payment as the second-most-important priority behind the payment on their primary residence.

FIGURE 6: PAYMENT OBLIGATIONS

If you were to have difficulty meeting all of your payment obligations over the next six months, which type of debt would you prioritize?

Respondents would prioritize mortgage or rent followed by auto debt. Medical debt falls at the bottom of the payment waterfall, preceded by other installment loans.



Sources: BofA Global Research and SurveyMonkey. The answer choice with the highest average ranking is the most preferred choice. As of January 27, 2023.

Allspring's approach to ABS investing

The distinctive characteristics of collateral types and diversity of issuers require a disciplined framework for credit analysis. Fundamental credit due diligence is paramount to consistent income generation and capital preservation. Furthermore, our team regards relative value and stress scenario risk assessment as inseparable. Credit due diligence is multi-level, with a comprehensive understanding and stress testing at the collateral, loan, and transaction levels. Stress testing over a full economic cycle, including recessionary shocks, is crucial to capturing the full income and return potential of a security.

Portfolio managers look for opportunities across all available resources, including the primary and secondary markets. We leverage strong and longstanding relationships with our counterparties, allowing us superior access to securities with attractive relative-value characteristics.

The ABS sector has historically offered significant opportunities to increase yield and improve credit quality while lowering volatility in an investment-grade fixed income portfolio. The asset class tends to be a less efficient part of the market due to its out-of-index nature. Its diversification benefits have the potential to insulate a portfolio from idiosyncratic risks, supporting outperformance and higher risk-adjusted returns.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

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Diversification does not ensure or guarantee better performance and cannot eliminate the risk of investment losses.

The ratings indicated are from Standard & Poor's, Moody's Investors Service, and/or Fitch Ratings Ltd. Credit-quality ratings: Credit-quality ratings apply to underlying holdings of the fund and not the fund itself.

Standard & Poor's rates the creditworthiness of bonds from AAA (highest) to D (lowest). Standard & Poor's rates the creditworthiness of short-term notes from SP-1 (highest) to SP-3 (lowest). Ratings from A to CCC may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the rating categories.

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Fitch rates the creditworthiness of bonds from AAA (highest) to D (lowest).

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