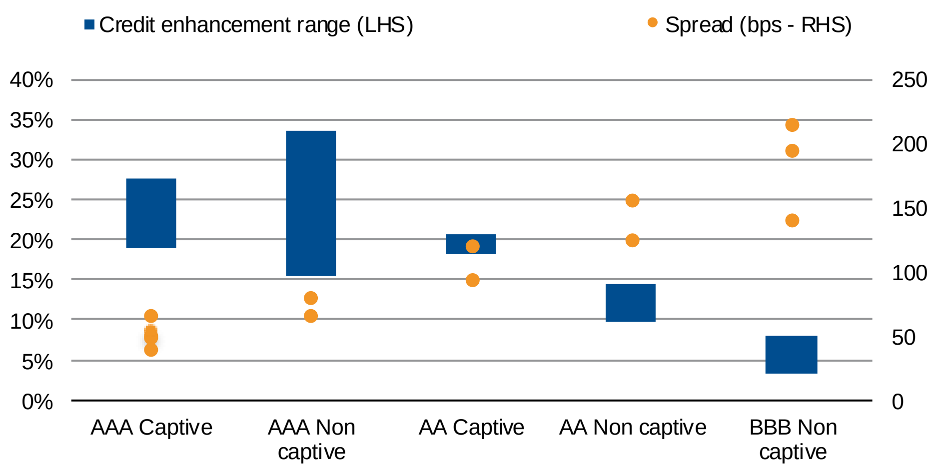
UK Auto ABS – challenges ahead
Residual-value risk and delinquency rates moving up

Bank lending activity is slowing down, owing to Brexit uncertainty and rising write-offs in consumer credit. The auto industry, meanwhile, is facing cyclical adjustments in the new car market, and prices could modestly decrease in the second-hand market. Scope expects senior tranches of UK auto ABS to maintain credit quality thanks to their available protection. Protection of mezzanine tranches, however, could prove insufficient to offset a bearish scenario.

Total issuance of UK Auto ABS reached EUR 8.1bn in 2018, the highest since the 2008 Global Financial Crisis. Of note, spreads at closing were higher in non-captive deals (those originated by banks) compared to those originated by car manufacturers' financing arms (captive), while credit enhancement levels were more volatile – see Figure 1. This partially reflects the volatile credit performance of non-captives and the fact that they are less experienced in originating auto ABS.

For originators with issuance from both periods, there has been a trend to higher spreads. Scope expects this to continue, commensurate with the rising risk profiles of UK Auto ABS.

Figure 1: 2018 UK Auto ABS credit enhancement vs spread at closing



Source: Bloomberg, JP Morgan, Scope

Weakening consumption and higher write-offs

Credit write-offs are expected to continue trending up given the pessimistic economic outlook for the UK. Under a no-deal Brexit scenario or with faster-than-expected interest-rates hikes, Scope expects credit losses for auto loans will move up to levels last seen in 2012, although tighter underwriting standards can mitigate any worsening in the situation.

This year is expected to be the weakest for the UK economy since the financial crisis: the Bank of England's 2019 GDP growth forecast was just 1.2%[1]. This pessimistic macro outlook will act as a drag on private consumption, further weakening vehicle demand under a weak pound.

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Related research

Auto ABS Rating Methodology
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[1] Press release on 6 February 2019

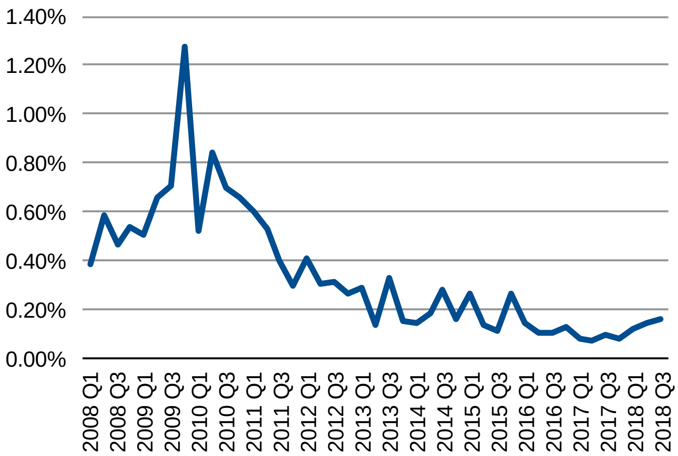
The quarterly consumer credit write-offs ratio (Figure 2) presents a stable historical performance and a reversion from the floor of Q4 2017. The rising trend observed recently indicates a worsening of credit performance in consumer lending.

Financial institutions, meanwhile, are behaving conservatively, tightening credit score criteria and controlling approval rates. The Credit Conditions Survey, published in January 2019 by the Bank of England, shows tighter underwriting standards since the first quarter of 2017, amid Brexit uncertainty (Figure 3).

The index of credit score criteria and proportion of approvals has recently gone from tightening to near-neutral, but it remains far from the loose credit conditions of 2012-2016. Lower risk appetite is likely to moderate rising credit risks in future UK auto transactions.

Figure 2: Consumer credit write-offs

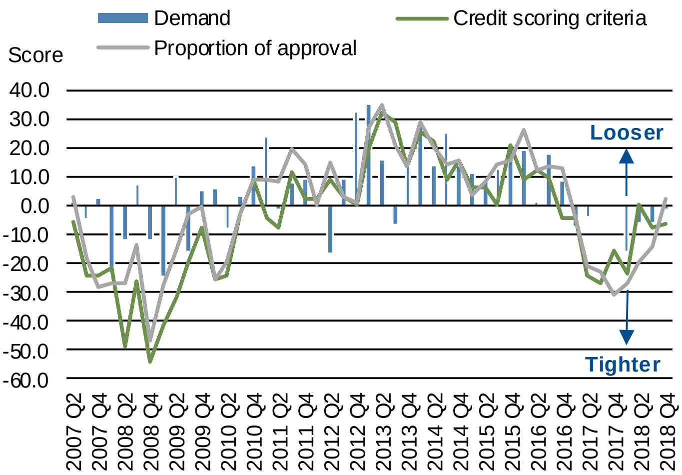
Quarterly consumer credit write-offs* in monetary financial institutes



*non-secured on dwellings and non credit card lending to individuals, ratio is calculated by quarterly write-offs/gross lending in past four quarters
Source: Bank of England, Scope

Figure 3: Credit Conditions Survey

Unsecured lending to households (excl. credit card loan)*



*above 0 indicates an expectation of looser condition over next 3 months period
Source: Bank of England

Chill in the vehicle market

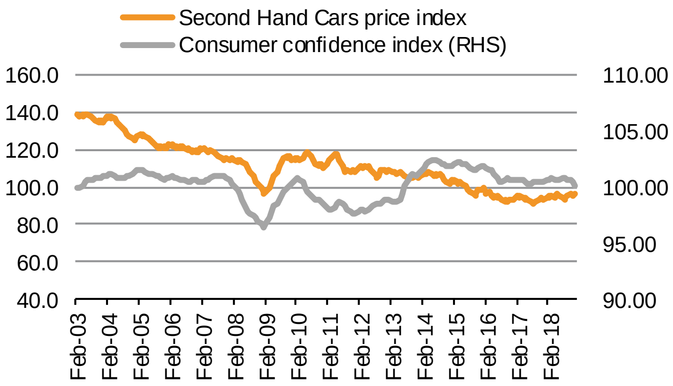
Used car prices about to fall as the boom in the vehicle market comes to an end.

Prices of second-hand petrol and diesel cars are both expected to decline as ample supply releases from booming car sales of previous years will not ease until 2020, along with weaker demand.

The new car market is experiencing a downward cyclical trend: 2018 new car registrations in the UK decreased by 6.8%. The 2019 new-car market could potentially even dip by 10% in the event of no-deal Brexit, according to Autovista. Meanwhile, residual values, regardless of model types, will decline this year by 1% for 36 month/60,000km vehicles.

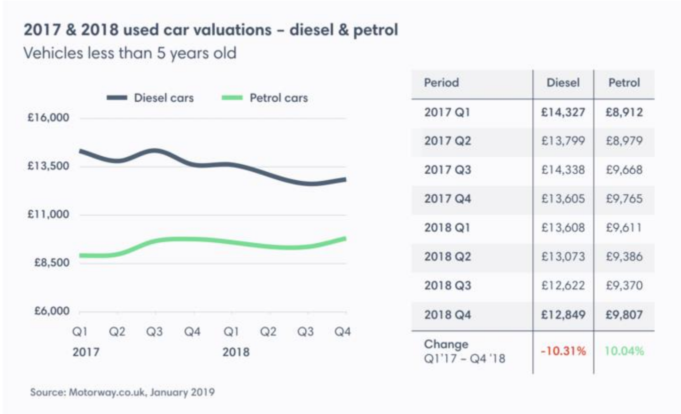
The consumer confidence index shares a long-term trend with second-hand car prices. The index has dropped below 100 for the second consecutive month (Figure 4). Second-hand car prices in 2018 remained steady overall, although petrol and diesel vehicles moved in opposite directions. Scope expects second-hand car prices for diesel vehicles to remain under pressure due to negative image and unsupportive government policy.

Figure 4: Vehicle index and consumer confidence index



Price index INDEX: 2015=100 Source: OECD, Office for National Statistics

Figure 5: Used car prices



Period	Diesel	Petrol
2017 Q1	£14,327	£8,912
2017 Q2	£13,799	£8,979
2017 Q3	£14,338	£9,668
2017 Q4	£13,605	£9,765
2018 Q1	£13,608	£9,611
2018 Q2	£13,073	£9,386
2018 Q3	£12,622	£9,370
2018 Q4	£12,849	£9,807
Change Q1'17 – Q4 '18	-10.31%	10.04%

Source: Motorway.co.uk

Mounting delinquencies in non-captive transactions

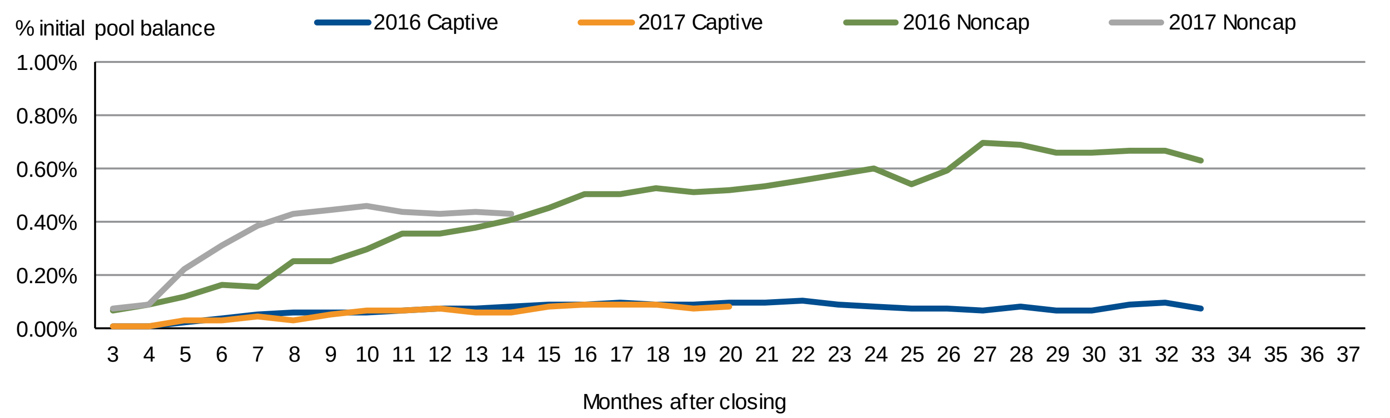
Non-captive transactions experience increasing delinquency rates; mezzanine tranches come under stress.

Unlike captive transactions, Scope expects the possibility of default in non-captive pools to increase as macro risks mount. This is because non-captives generally position themselves in used-car finance and have riskier borrower profiles than captive firms. The perception of higher credit risk and less stable pool performance in non-captive transactions partly explains their higher required offering spreads in rated tranches relative to captives.

Ninety-day-plus delinquency rates are trending up in non-captive transactions, raising concerns about the back-loaded default timing curve that could worsen if the economy performs worse than expectations (Figure 6). By comparison, the performance of captive auto ABS remains strong amid Brexit uncertainty and a weaker macro situation in the UK. Scope expects the differences in delinquencies between captive and non-captive to widen in 2019, mainly due to the differences in risk appetite and market positions.

Scope tested non-captive transactions by stressing an increase in the base-case default rate by 20%. The results show mezzanine tranches are exposed to 1-2 notches of adverse impact and no impact on senior tranches.

Figure 6: UK Auto ABS delinquency rates (90 day+) – per closing year and originator type[2]



Source: Bloomberg, Investor reports, Scope

[2] 2016 captive transactions: Driver UK Four, Driver UK Multi-Compartment SA Comp Private Driver UK 2016-1, E-CARAT 6, Globaldrive Auto Receivables UK 2016-A, E-CARAT 7. 2016 non-captive transactions: Turbo Finance 7, Motor 2016-1, Turbo Finance 6. 2017 captive transactions: Driver UK Five, Globaldrive Auto Receivables UK 2017-A, E-CARAT 8, Silver Arrow UK 2017-1, Bavarian Sky UK Plc 1, Driver UK Six. 2017 non-captive transaction include Motor 2017-1.

Market value risks cast a shadow on captive mezzanine notes

A transaction with predominantly PCP may have one-notch downside in mezzanine tranches under a stressed market-value loss.

Mezzanine notes of captive transactions, assuming predominantly personal contract purchases (PCP), are exposed to one-notch sensitivity by stressing a decline in monthly vehicle market-value to accelerate by 10%.

Auto ABS transactions in the UK are mostly structured to securitise vehicle value, unlike continental European Auto ABS. Final balloon payments in PCP – a high proportion of captive deals especially – are optional as opposed to an obligation in traditional leasing products. In addition, permission for voluntary termination in the UK can make UK transactions sensitive to market-value risk.

The voluntary termination rate in 2016 and 2017 transactions shows 0.2%-1.5% of voluntary returned gross book value, as opposed to the closed-pool value after deals seasoned for around 30 months. Scope expects an increase in vehicle turn-in rates because of a pessimistic view of the second-hand market in 2019.

A faster decline in vehicle market-value can result in higher market-value loss at voluntary turned-in point and at maturity. For example, if the monthly vehicle market-value decline rate of 1.6% is accelerated by 10% to reach 1.8%, the additional vehicle value-decline at maturity is around 6%-7% in a pool with a weighted remaining loan term of 36 months.

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