European Auto ABS: Benefits of Transparency vs. The Double-Edged Sword of Standardisation

Special Comment

Scope Ratings welcomes the initiative to increase standardisation in the European securitisation market – if it strengthens transparency and enables better credit risk analysis of transactions. More transparency reduces unexpected risk for investors and decreases costs for underlying real economic transactions. However, standardisation of transactions can prove a double-edged sword and should not divert market participants from careful credit analysis.

Transparency increases investor universe, reduces spreads

Scope values transparency and welcomes initiatives for better disclosure among originators and issuers. Better standardisation of reported data also aids transparency through common and clearly defined delinquency and default metrics, for example. Reliable and extensive comparable data is necessary – but not sufficient – for good credit analysis.

The value of loan-level data for Auto ABS transactions is still to be exploited. We believe credit risk analysis can benefit from loan-level data as it can aggregate market information, allowing a deeper understanding of fundamental risk drivers behind Auto ABS performance. For single transactions considered in isolation, loan-level data is mostly useful for leveraging the originator's knowledge of credits in the securitised portfolio.

We believe investor demand rewards transparency, as it enables correct assessment of risks. More transparent issuances should attract a broader investor universe, which, combined with reduced transaction costs, leads to lower financing costs for the originator.

Thorough analysis becomes simpler

A thorough analysis of each securitisation transaction cannot be waived, even when transparency and standardisation exist. Investors still have to look at the interplay of asset quality, financial structure and counterparty risk – the main pillars of Scope's structured finance rating methodologies. But the key point here is that transparency through standardisation allows investors to more efficiently and accurately assess their investment, and reduces the risk of unexpected losses in their portfolio, and systemic risk in the industry as a result.

Standardisation of features can lead to less scrutiny

Scope cautions on the risk of reduced scrutiny when standardisation of transactions, features and characteristics is in place. The illusion of control through standardisation can lead to less scrutiny among market participants. A noteworthy example, 'standard' subprime RMBS in the US was – combined with other factors – at the core of the financial crisis.

Our credit analysis of Auto ABS transactions will see through apparent standardisation to capture differences in the credit quality of securitisations – an approach we believe sound investors will endorse.

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Standardisation of features could distort Auto ABS market

We see a risk of market distortion if standardisation goes beyond common definitions for information provided to market participants. Standardisation of transactions that excludes certain collateral types would alter Auto ABS characteristics, and that against the backdrop of the unquestionable credit performance of this asset class, due as much to auto investors' preferences as to consumer financing needs.

For good reason, forms of Auto ABS vary between European jurisdictions. Forced standardisation would ignore the different designs of auto financing in Europe, distorting the individual market's established business models with a risk of impairing the economy at a pan-European level.

Residual value in Auto ABS

Regulators see residual value in Auto ABS transactions as a source of risk which does not belong to a securitisation because it has an important component of market value risk. It is currently being discussed whether Auto ABS transactions with exposure to residual value should also benefit from favourable regulatory capital requirements.

In Scope's view, this discussion is driven largely by semantics because any securitisation of secured exposures – whether Auto ABS, RMBS or SME CLO – is effectively exposed to market value risk. Upon default of the obligor, collateral is typically liquidated by selling it on the market. This is when market value risk becomes relevant, and why rating agencies and investors haircut the collateral value when calculating loss given default. While residual value risk is more prominent in transactions where only the residual value is securitised (i.e. pure asset financing), it is less common in standard Auto ABS, where typically the dealer, the borrower or the lessee will bear residual value risk. Which indeed makes the assumption of market value risk in Auto ABS similar to that in RMBS or SME CLO.

Coordinating role of securitisation

Elimination of certain structural features from Auto ABS structures could reduce the ability of securitisation to coordinate consumer demand for credit and investors' supply of savings. In this respect 'simpler' and standardised structures could be less efficient, which makes them indirectly weaker from a credit point of view.

Without interest rate swaps, for example, the risk of interest rate mismatches has to be covered by credit enhancement, resulting in higher Auto ABS costs that are ultimately passed to end consumers. Standardisation also reduces flexibility in meeting the needs of real-money investors'.

Conclusion

Standardisation is a double-edged sword: it can significantly increase efficiency in markets when it is the result from a market-driven assessment on the marginal cost and marginal benefit of transparency; but it can also bias market agents towards suboptimal and inefficient practices.

As a final remark, the discussion of transparency and standardisation of Auto ABS in Europe should ultimately acknowledge the very good historical performance of Auto ABS in our continent, particularly during the last financial crisis.

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