Credit Market Research

Delinquencies and Downgrades — The Recession's Impact on U.S. Consumer ABS Ratings

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Related Research

- *U.S. Structured Finance 2010 Outlook, Dec. 8, 2009*
- *Term ABS Credit Action Report: September 2009, Oct. 26, 2009*
- *Fitch Ratings Global Structured Finance 2008 Transition and Default Study, March 17, 2009*

Summary

The collapse of U.S. housing market fundamentals has had a severe negative impact on residential mortgage-backed securities (RMBS). Since the beginning of the financial and economic crisis in late 2007, credit quality in the RMBS sector has deteriorated at a rapid pace, as mortgage delinquency rates have soared to multiples of historic levels. Disruptions in the financial markets and the accompanying housing downturn have been nearly without precedent, affecting every corner of structured finance.

However, outside of the extreme negative rating volatility recorded in RMBS and in collateralized debt obligations (CDO) exposed to the housing and financial crisis, other areas of structured finance have to date experienced downgrade rates more typical of a recessionary climate. In many respects, collateral and ratings have demonstrated performance trends similar to the previous recession in 2001, which lasted a total of eight months but which had consequences that extended beyond as the path towards a full economic recovery took several quarters to be realized.

In this new study, Fitch describes the impact to date of the recessionary surge in delinquency rates on credit quality across consumer asset-backed securities (ABS). In addition, special attention is devoted to isolated market events that have had a direct impact on corresponding rating performance. The spike in unemployment in 2009 and other macroeconomic stresses have affected consumer ABS sectors, but the magnitude has varied considerably, especially relative to developments in subprime RMBS and CDOs. In fact, despite the negative backdrop, upgrades outnumbered downgrades across consumer ABS.

Highlights

While no sector has been completely immune to the recession, the impact on credit quality and subsequently on rating activity has varied across sectors. Differences reflect distinct collateral performance, structural attributes, isolated sector-specific developments, as well as differences in timing relative to the initial dislocation in the housing and credit markets. Fitch believes the resilience of ABS ratings is driven by several factors, including:

- Structural features inherent in most ABS transactions that enable rapid deleveraging.
- Conservative loss expectations and stresses that were derived from prior recessionary environments.
- Stable or increasing credit enhancement levels over time.
- Consistent collateral attributes and straight-forward structures.
- Ongoing involvement or retained interest by originator, i.e. few originate-to-sell models.

- Delinquency rates have varied considerably across product types in structured finance. Within nonmortgage ABS, the most recent data showed 60+ day delinquency rates of 4.1% and 0.8% across prime credit card and prime auto loan transactions, respectively. Meanwhile, student loans in forbearance reached 10.7% in the first half of this year. Through September, the downgrade rate on Fitch-rated credit card, auto, and student loan bonds was 0.9%, 3.0% and 6.6%, respectively. In addition, impairment rates across these three areas have to date either been non-existent or remained contained. No credit card or student loan ABS became impaired in the first nine months of this year, while only one auto transaction was lowered to ‘CC’ or below.

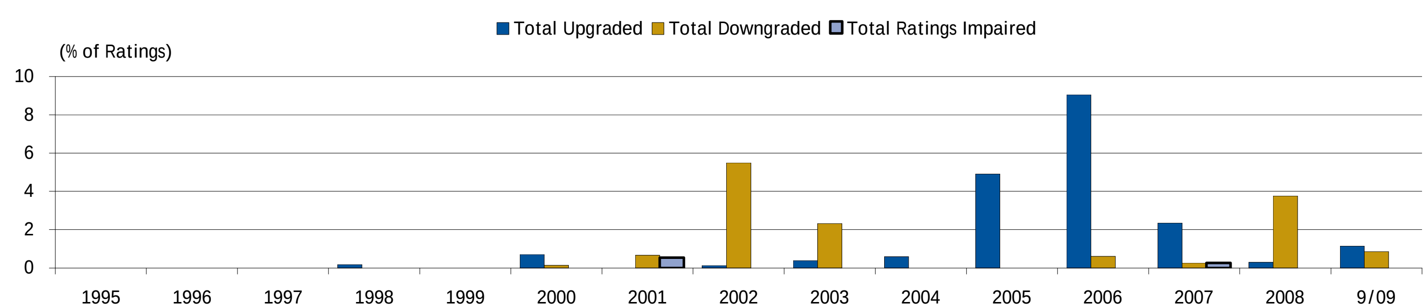
U.S. ABS

The ABS sector continued to display resistance to economic forces that have affected other structured finance segments. Although downgrades did increase in 2009, clearly a product of the growing stresses faced by U.S. consumers, ABS has largely been able to avoid the widespread rating declines that have been seen in the other major structured finance sectors. Consumer ABS sectors have been impacted through indirect channels affecting the economy, particularly consumer behavior, which has been affected by rising unemployment, a curtailment of available credit, falling consumer spending and investment, and a drop in household net worth.

The direct impact of the cooling housing market and problems in the subprime mortgage sector on ABS has been limited, particularly from a ratings standpoint. However, the severe economic recession and its impact on the consumer now outweigh the effects of the housing downturn. The employment situation is the main driver of borrower defaults in the consumer ABS sectors. With unemployment already eclipsing 10%, and expected to remain elevated, the health of consumer ABS is being tested. While asset performance deterioration is expected to continue throughout the remainder of 2009 and into 2010, downgrades at the ‘AAA’ level for credit card, auto, and student loan ABS are expected to be de minimus.

As illustrated in the charts below, negative rating performance to date stands below levels experienced during the prior U.S. recession in 2001. For credit card ABS, this was partly due to proactive measures taken by issuers to enhance collateral composition and performance measures as well as provide additional support to preserve ratings. Consistent underwriting standards, higher credit enhancement levels, and rational competition have also helped to limit downgrades. Further, the practice of shifting away from underwriting and issuing purely subprime assets, particularly in traditional consumer ABS sectors such as autos and credit cards, has helped shield issuers from experiencing large scale downgrades.

U.S. Credit Card ABS Rating Action Summary
(Includes Prime and Subprime Credit Card ABS)



U.S. Credit Card ABS Rating Action Summary

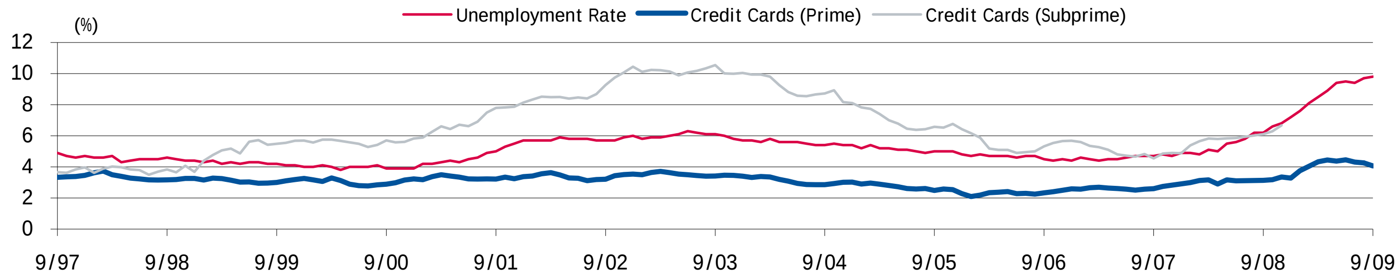
(% of Ratings)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Sep-09
IG Upgraded	0.0	0.0	0.0	0.2	0.0	0.7	0.0	0.1	0.4	0.0	3.7	10.1	2.5	0.3	1.2
SG Upgraded	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	6.8	15.8	0.0	0.0	0.0	0.0
IG Downgraded	0.0	0.0	0.0	0.0	0.0	0.1	0.7	5.5	2.5	0.0	0.0	0.4	0.0	3.1	0.9
SG Downgraded	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	2.0	3.6	11.1	0.0
IG Impaired	0.0	0.0	0.0	0.0	0.0	0.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SG Impaired	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	3.6	0.0	0.0
Total Upgraded	0.0	0.0	0.0	0.2	0.0	0.7	0.0	0.1	0.4	0.6	4.9	9.1	2.3	0.3	1.1
Total Downgraded	0.0	0.0	0.0	0.0	0.0	0.1	0.7	5.5	2.3	0.0	0.0	0.6	0.3	3.8	0.9
Total Impaired	0.0	0.0	0.0	0.0	0.0	0.0	0.5	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.0

IG – Investment grade. SG – Speculative grade.

U.S. Credit Card Delinquencies

(60+ Day Delinquencies)

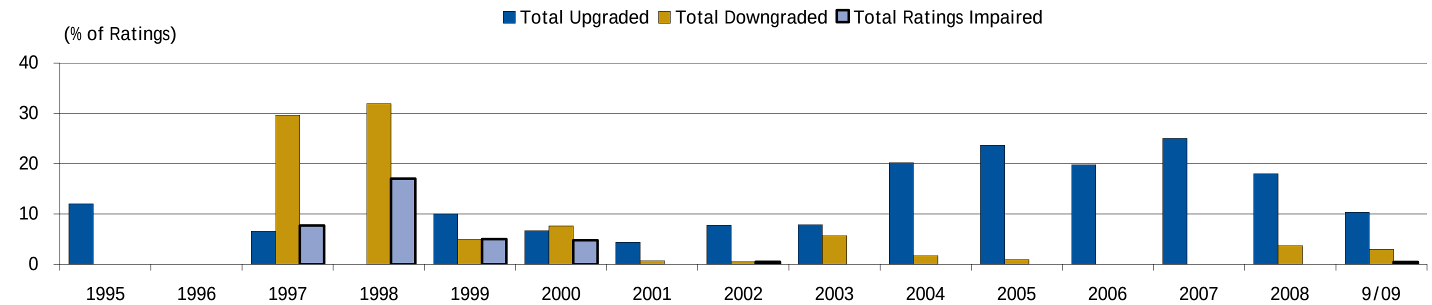


Source: Fitch Ratings and Bureau of Labor Statistics.

- In 2002, against sluggish macroeconomic conditions, the credit card ABS sector exhibited stable credit quality trends for prime consumer assets and deteriorating trends for subprime assets. With unemployment peaking at the end of 2002, at 6%, overall prime credit card chargeoffs remained flat and accounts 60 days or more delinquent ran about 3% due to a rise in personal bankruptcies. Over the same time frame, subprime credit card chargeoffs and delinquencies deteriorated more than their prime counterparts did due to aggressive underwriting and slowing receivables growth, with the delinquency rate topping 10%. As a result, credit card downgrade rates peaked in 2002, with approximately 5.5% (concentrated primarily in subprime assets) experiencing negative rating actions, while impairments also materialized during 2001, with approximately 1% being lowered to 'CC' or below in that year.
- In comparison, even though both unemployment and delinquency rates are sharply higher during this economic downturn, the downgrade rate for credit card ABS has not reached the same level seen during what is generally referred to as the 2001–2002 recession. Indeed, there has been only 0.9% of credit card ABS downgraded as of September of this year despite unemployment averaging just below 10% and prime credit card delinquencies hitting 4.1% at the end of September. However, the relatively more positive rating performance during this most recent downturn is more a function of market events than developing economic conditions. Card issuers have offset higher defaults and delinquencies by taking steps to boost portfolio performance measures through re-pricing and discounting. In addition, they avoided potential downgrades by adding credit enhancement to the trusts by way of increased subordination and/or overcollateralization.

- More recent data indicate that late payments on outstanding U.S. credit card balances rose again in November, falling just shy of record highs as U.S. consumers continue to struggle with debt loads amid the weak unemployment situation. Despite a higher unemployment outlook and rising credit card delinquencies, Fitch expects the ratings for senior tranches of U.S. credit card ABS to remain stable as the pace of performance deterioration levels off and as a result of the actions undertaken by issuers already. However, the outlook for subordinated tranches remains negative, particularly given recent delinquency and personal bankruptcy filing trends affecting ABS

U.S. Auto ABS Rating Action Summary
(Includes Auto Loans and Leases)



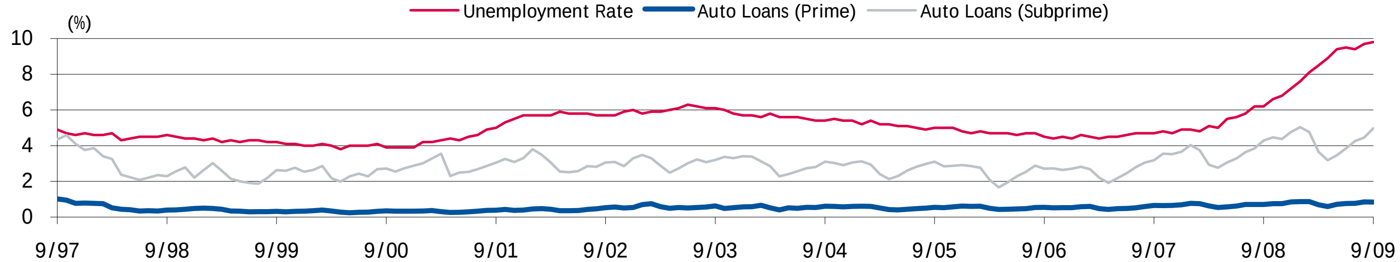
US Auto ABS Rating Action Summary

(% of Ratings)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Sep-09
IG Upgraded	0.0	0.0	7.9	0.0	0.0	6.7	3.3	5.7	6.5	19.6	4.9	17.8	23.3	18.0	10.6
SG Upgraded	0.0	0.0	0.0	0.0	13.9	6.3	11.1	27.8	30.8	0.0	41.2	46.7	50.0	17.6	8.7
IG Downgraded	0.0	0.0	23.7	22.5	0.0	2.2	0.8	0.0	6.0	0.9	0.9	0.0	0.0	2.9	2.2
SG Downgraded	0.0	0.0	60.0	60.9	3.8	37.5	0.0	5.6	0.0	0.0	0.0	0.0	0.0	11.8	8.7
IG Impaired	0.0	0.0	3.9	2.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SG Impaired	0.0	0.0	26.7	60.9	1.3	31.3	0.0	5.6	0.0	0.0	0.0	0.0	0.0	0.0	4.3
Total Upgraded	12.0	0.0	6.6	0.0	10.0	6.7	4.3	7.7	7.9	20.2	23.7	19.8	25.0	18.0	10.3
Total Downgraded	0.0	0.0	29.7	31.9	5.0	7.6	0.7	0.5	5.7	1.7	0.9	0.0	0.0	3.7	3.0
Total Impaired	0.0	0.0	7.7	17.0	5.0	4.8	0.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.5

IG – Investment grade. SG – Speculative grade.

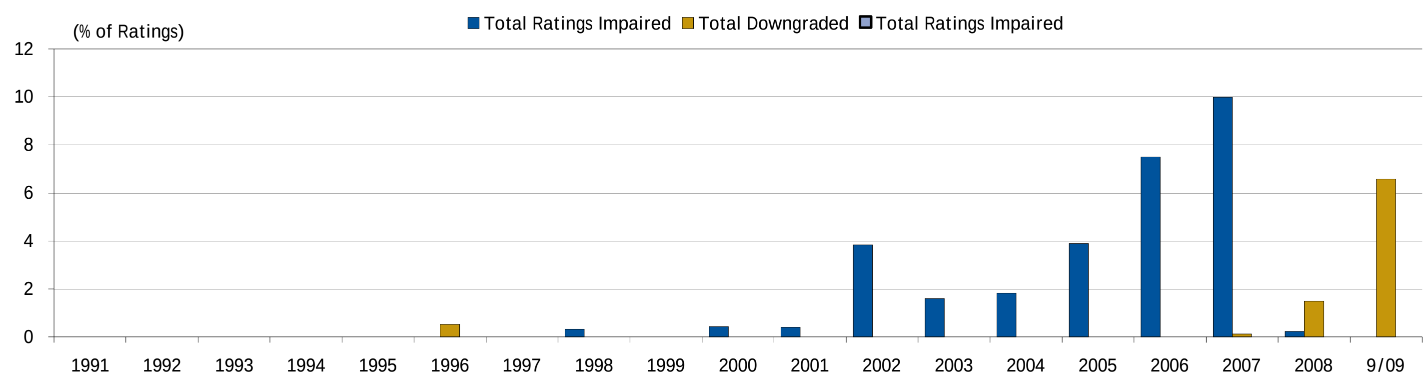
U.S. Auto Loan Delinquencies
(60+ Day Delinquencies)



Source: Fitch Ratings and Bureau of Labor Statistics.

- Auto loan performance has mirrored some of the trends seen in the credit card sector. The prime and subprime auto delinquency and loss indices deteriorated throughout 2002 (prime delinquencies averaging more than 50 BPs, while subprime delinquencies peaked in 2002 during January, at 3.8%) as consumer health declined and the used car market remained weak. Increases were evident across virtually all issuers, with greater volatility in the subprime market. Auto ABS saw downgrades peak in 2003, with 5.5% being lowered.
- Despite escalating unemployment levels, combined with sharply higher delinquencies across both prime (0.8% at the end of September) and subprime (5%) auto loans, the downgrade rate, at 3.0% through September of this year, was considerably lower than the rate reported during the 2001–2002 recession (5.5%). Adequate levels of credit enhancement present in prime auto loan ABS deals have helped shield the ratings from the economic environment of the past couple of years, including elevated unemployment levels and the risks surrounding the state of auto manufacturers. In fact, the majority of auto downgrades historically have been subprime related. However, it is worth noting that the current criteria employed looks to prior recessionary environments when deriving the base case loss proxy. For example, credit enhancement levels in late 2008 and 2009 auto transactions have increased approximately 10%–15% when compared to prior years, corresponding with higher loss proxy forecasts for future securitized pools. In addition, the strength of the used vehicle market in 2009 has also helped to moderate loss severity and slow the rate of rising losses.
- Auto loan ABS collateral performance is expected to continue to deteriorate in the coming months, brought on by both the high unemployment rate and seasonal trends.

U.S. Student Loan ABS Rating Action Summary



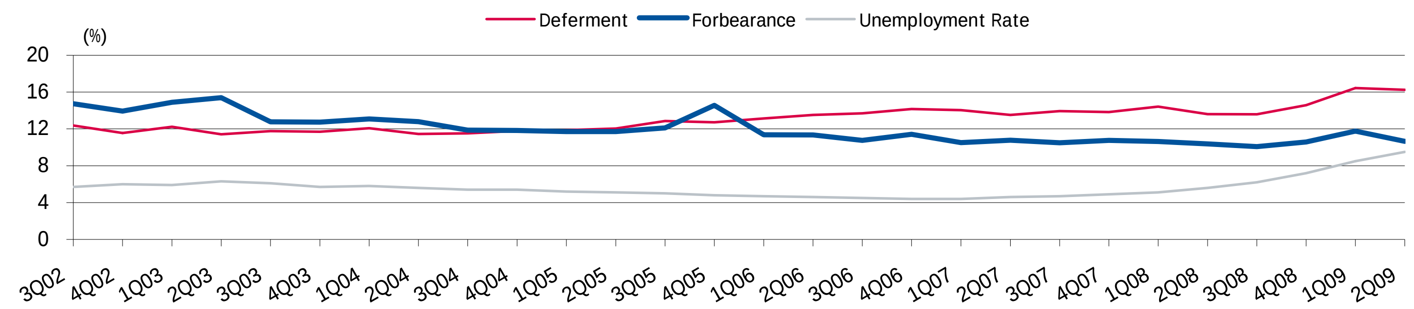
US Student Loan ABS Rating Action Summary

(% of Ratings)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Sep-09
IG Upgraded	0.0	0.0	0.0	0.3	0.0	0.4	0.4	3.8	1.6	1.8	3.9	7.5	10.0	0.2	0.0
SG Upgraded	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0	7.5	0.0	0.0	0.0
IG Downgraded	0.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	1.5	6.6
SG Downgraded	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IG Impaired	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SG Impaired	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Upgraded	0.0	0.0	0.0	0.3	0.0	0.4	0.4	3.8	1.6	1.8	3.9	7.5	10.0	0.2	0.0
Total Downgraded	0.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	1.5	6.6
Total Impaired	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

IG – Investment grade. SG – Speculative grade.

U.S. Student Loan Deferment and Forbearance Index



Source: Fitch Ratings and Bureau of Labor Statistics.

- As both the forbearance rate and the deferment rate in the student loan sector have soared to record levels, averaging 10.7% and 16.2%, respectively, in the first half of 2009, the downgrade rate has also increased sharply, with nearly 6.6% of student loan ABS being lowered through September. During the 2001–2002 recession, forbearance rates exceeded 14% while deferment rates averaged about 12% in 2002; however, downgrades in the student loan sector were negligible at best during that period. Again, similar to what occurred in the credit card sector, the divergence in rating activity during this most recent recessionary period and that of the 2001–2002 period was attributed to specific market events rather than changing economic dynamics. Negative rating volatility in the student loan sector has been sharply higher during this most recent recessionary period, primarily as a result of the recent auction-rate market disruption.