Commentary

European Auto ABS — Gear Change From Ownership to Usage

DBRS Morningstar
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Overview

Changes in customer behaviour, new business models, and digitalisation have disrupted several industries over recent years and the automotive sector and the financial services supporting it are no exception. Across the automotive industry, the mentality is changing at pace, with customers switching from vehicle ownership to usage.

Customers are seeking more flexible, lifestyle-driven solutions that focus on the driving experience and digitalisation is also changing customer attitudes, with many buyers starting and completing their purchases online. Most of these trends appeared before 2020 and the effects of the Coronavirus Pandemic (COVID-19) have acted as a further catalyst, accelerating the disruption.

DBRS Morningstar continues to monitor these trends and expects changes in the nature of Auto ABS portfolios as a result. These changes are likely to affect the underlying collateral, specifically increasing market value risk in lieu of credit risk and will need to be considered in the analysis. Overall, DBRS Morningstar finds:

1. Changing Finance: Growing use of balloon loan finance and leasing, with more lenders making use of balloon loans to finance car purchases, specifically in new markets.
2. Supportive Environment: The economic environment and the use of securitisation have been supportive in allowing finance companies to adjust their products to support trade cycle management.
3. Digitalisation Introduces New Originators: New digital sales platforms have supported growth in new finance channels. These have been finding their niche in auto markets and have been making use of securitisation to support their growth.

New Finance Products Emerge

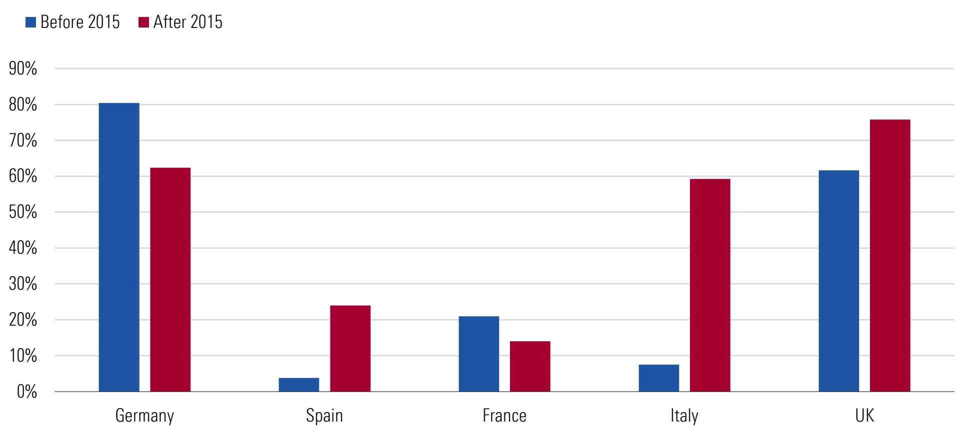
Historically, captive finance companies have used franchised dealer networks to offer hire purchase-type loans in Germany or in the United Kingdom, where security over the underlying vehicles allows for prompt repossession and recovery in case of default. In these markets, loan products have evolved over time to support a wider trade cycle management approach (TCM) pursued by captive finance companies to support new vehicle sales and to shorten the ownership or usage cycle. Traditional, equal payment amortising loans have been replaced with loans that include a balloon payment at contract maturity.

Balloon loans are typically characterised by equal monthly instalments until the final payment date when a final larger instalment (the balloon) becomes due. In most markets, under a balloon loan agreement the borrower has the contractual obligation to repay this final balloon payment, although there are often dealer buyback arrangements in place that kick in before this. In this way, the customer's amortising balance is aligned with the depreciation costs of the vehicle while it is being used.

While firmly established in Germany and the UK, we have observed a growth in the origination of auto loans with TCM characteristics in markets that have traditionally adopted classic amortising loans. Captive finance companies have more recently achieved higher penetration rates through these product types for new vehicle sales in Southern Europe. We analysed DBRS Morningstar-rated Auto ABS transactions and observed growing balloon exposure for transactions in Spain and in Italy since 2015.

The story is different in France and captive finance companies have been targeting leasing contracts to private customers instead of loans. DBRS Morningstar has noticed an increase of Auto ABS issuance in France backed by auto lease receivables. Within the last year, DBRS Morningstar has assigned ratings to leasing portfolios originated by the captive finance arms of Renault, Daimler, and BMW.

Exhibit 1 Balloon Exposure (%) of DBRS Morningstar's Rated Transactions Including Balloon Loans or PCP



Source: DBRS Morningstar.

Balloon Financing

The balloon payment is typically aligned with the expected market value of a vehicle at contract maturity, although strategies can vary according to the objectives of the finance provider. Captive finance companies are often inclined to set aggressive (higher) balloon payments to support the sales objectives of their manufacturer. However, this is a balancing act between attractive low monthly payments and high balloon payments at the end of the term. While lower monthly instalments make purchases more affordable, they risk sacrificing the equity position for the customer at maturity, which would likely be used to facilitate their next vehicle purchase.

In the UK, personal contract purchase (PCP) agreements have a similar payment schedule and incorporate a guaranteed future value applicable at the contract's maturity that is agreed at inception. These contracts offer the customer various options at maturity: (1) return the vehicle to the lender in lieu of settling the loan; (2) pay the optional balloon payment to settle the loan and purchase the vehicle; (3) request the refinancing of the balloon payment from the lender and retain the vehicle; (4) negotiate the sale of the vehicle to a dealer, who in turn settles the outstanding finance amount, this allows any resulting equity to become available as a deposit for a new vehicle purchase.

We continue to observe captives setting these guaranteed future values in close alignment with the expected residual values as this allows for competitive monthly instalments. Noncaptives are typically more prudent and focus on avoiding losses at the end of the contract should a customer elect to return the vehicle.

TCM products allow for a lower monthly payment compared with a standard fully amortising loan with the same contract tenor, deposit, and interest rate. However, they introduce additional risks: payment risk associated with the customer’s ability to meet the larger final balloon amount and direct residual value risk/market risk where the guaranteed future value ends up being higher than the market value of the car, this may result in losses for dealers or financial captives depending on the entity ultimately liable.

Drivers for Changing Financing Terms

DBRS Morningstar considers there to be several drivers behind this shift: economics, usage demands, and customer interests.

Customer Utility

Customers have demonstrated a change in behaviour, focusing their attention on usage rather than ownership and seeking mobility-as-a-service solutions. Urban residents are now questioning the rationale behind purchasing and owning a car alongside additional costs such as insurance, taxes, parking etc.. As a result, new business models of the shared economy that allow customers to share vehicles in densely populated urban areas have grown. To date, they have shown mixed results in terms of profitability and have been limited in their geographical spread. However, they continue to evolve with innovative solutions to increase usage and appeal to drivers that may otherwise not purchase a vehicle.

Mobility solutions have expanded through pay per usage models, where customers pay a small monthly rate plus fees depending on mileage, along with subscription packages. Here, the customer payment covers almost all related vehicle expenses, and is similar to an operational lease or a long-medium term rental, while also allowing for contract termination rights on a monthly basis.

We have started to observe subscription solutions now being offered by car rental companies and financial companies to improve their fleet utilisation rates and to add innovative remarketing channels for the increasing stock of younger used vehicles. Furthermore, new digital dealers that offer used vehicles for sale with door-to-door delivery have started to advertise subscription packages. This has been further demonstrated by Cazoo's recent acquisition of various leading vehicle subscription disruptors in the UK and Germany.

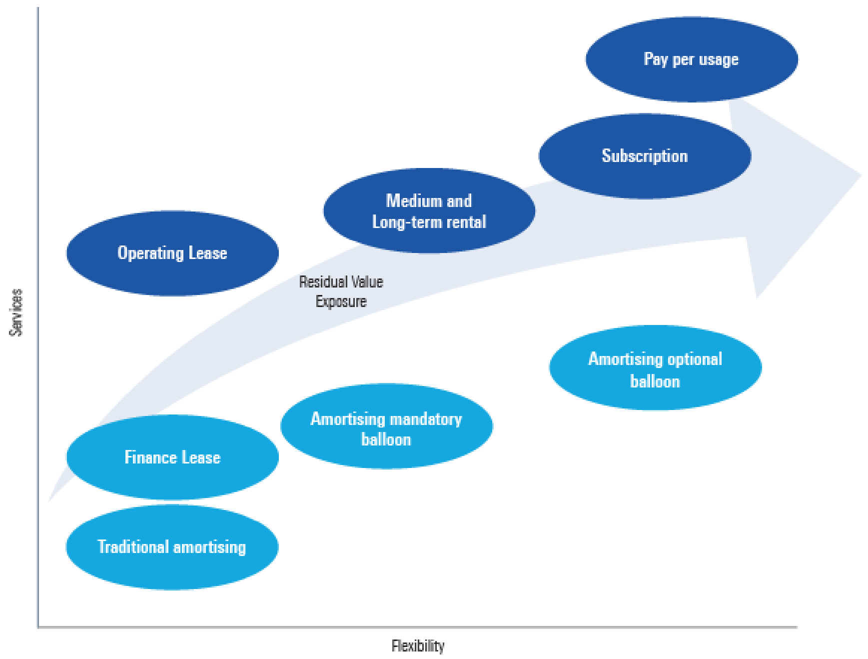
Customers' attitudes towards enjoying and valuing the driving experience itself have also supported innovative products and led to vehicle segment changes. Manufacturers have increased their premium vehicle offerings and have been able to utilise innovative financing products, including TCM products as mentioned above, making expensive vehicles more affordable and accessible, resulting in a change in vehicle mix.

Traditional leasing and medium-long term rental products that might otherwise have been targeted at businesses have also been offered to private individuals. This has supported an increase in private car usage in Europe over recent years. As these products have developed they have facilitated the growth and adoption of other ancillary products (e.g. insurance, maintenance, tyres).

Whilst portfolios with some of these innovative short-term customer finance offerings have not yet appeared in the European Auto ABS market, we expect that this may change as adoption rates increase.

Exhibit 2 plots these product types on two dimensions according to the services provided and the flexibility offered. In the lower left corner, we show traditional amortising and financial leasing contracts, while on the upper right corner the most innovative mobility solutions. As the arrow highlights, the residual value exposure increases along the spectrum because of the shortening contract tenors and the need to constantly recycle vehicle usage.

Exhibit 2 Product's Spectrum



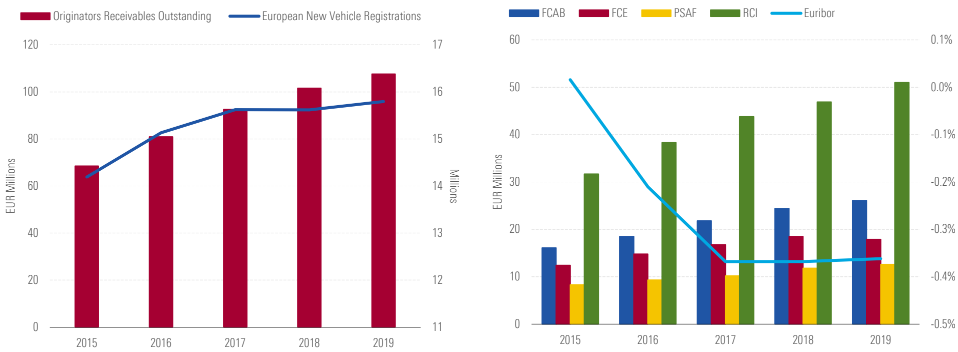
Source: DBRS Morningstar.

Supportive Economic Environment

Macroeconomic fundamentals and structural drivers have played their part too. Low interest rates, falling unemployment levels, and rising house prices have allowed an expansion of automotive finance to support vehicle sales and resulted in an increase in the balance sheets of captive finance lenders. These lenders have been able to expand their range of financial products and mobility offers with a low cost of borrowing. Combined with low default levels, this has supported their ability to offer low lending rates and keep monthly payments attractive.

The use of the securitisation market for funding has also been supportive. Given the strong economic backdrop and positive performance, this short-duration investment has continued to expand with more issuers and regions making use of Auto ABS issuance, and attracting regular investor interest.

Exhibit 3 European Financial Captives Outstanding Portfolio Balances vs. European New Vehicle Registrations and Euribor



Source: Euribor, ACEA, financial statements and investor presentations of main European OEMs/financial captives.

Finance Support for Changing Behaviour

The shifts in consumer behaviour have been actively supported by captive finance companies through their promotion of TCM products, lengthening comparable financing tenors, and lowering interest rates. Among transactions we rate, we note that as balloon loans have become commonplace, the weighted average original tenors of transactions including only traditional amortising loans have increased, reflecting the competition between product types for comparable monthly instalments. At the same time, the weighted interest average rate for transactions has decreased in certain jurisdictions, e.g. Germany.

Exhibit 4 Weighted-Average Interest Rate of German Transactions Rated by DBRS Morningstar

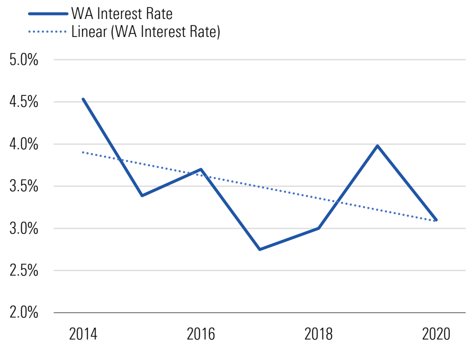
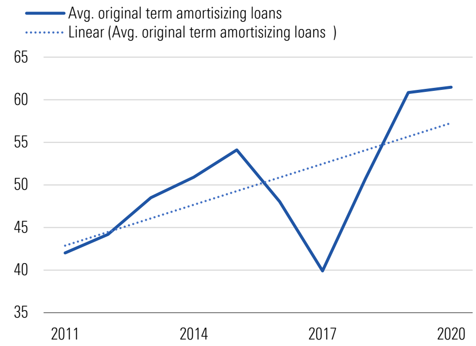


Exhibit 5 Average Original Term of European Transactions (Amortising Loans) Rated by DBRS Morningstar



Source: DBRS Morningstar.

Upmarket Shift Changes Mix

Customers' attitudes towards upmarket vehicles and their ongoing desire to compete with their next door neighbours have been met by vehicle manufacturers increasing their premium vehicle offerings. They have been able to utilise TCM to make expensive vehicles more affordable and accessible. This has resulted in a change in vehicle mix amongst Auto ABS portfolios according to our analysis, which found:

1. The brand mix in the five major European markets demonstrates a shift from mass market to premium brands. The percentage of new car registrations associated with premium brands in Europe increased by 4% over the last decade. While the UK showed a substantial increase, Germany remains the country with the highest percentage of premium vehicles, with approximately a third of registered vehicles associated with premium brands. Only the French market has remained stable with higher volumes of mass market vehicle registrations.

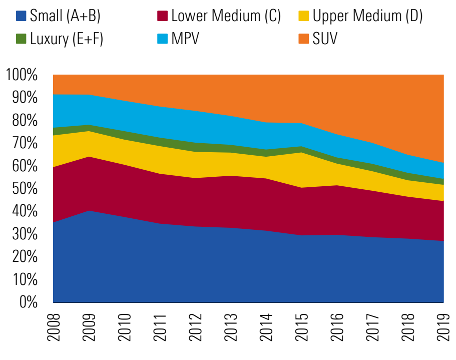
New Vehicle Registrations: Premium Brand Mix

	Germany	UK	Spain	France	Italy
% Premium vehicles 2019[1]	30.9%	24.4%	17.4%	14.0%	19.2%

1 As of December 2019.
Source: ACEA, CCFA, KBA, ANFIA, GANVAM, SMMT.
Premium brands: BMW, Lexus, Mercedes-Benz, MINI, Lexus, Volvo, Audi, Jaguar, Land Rover etc.

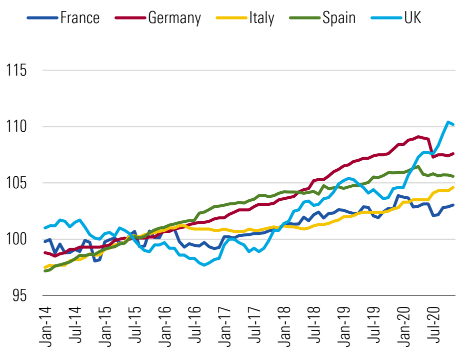
2. Vehicle segment mix has changed substantially reflecting the broadening range of sport utility vehicle (SUV) models across all brands. These now account for almost 40% of total new vehicle registrations. The growth in SUVs has been largely offset by the decrease in the smaller A and B segment vehicle types.
3. Even considering inflation, these brand and vehicle segment trends have contributed to an increase in average vehicle prices in the five major European markets over the last five years.

Exhibit 6 Europe's Vehicle Segment Mix



Source: ACEA.

Exhibit 7 Vehicles' Price Index (2015=100)

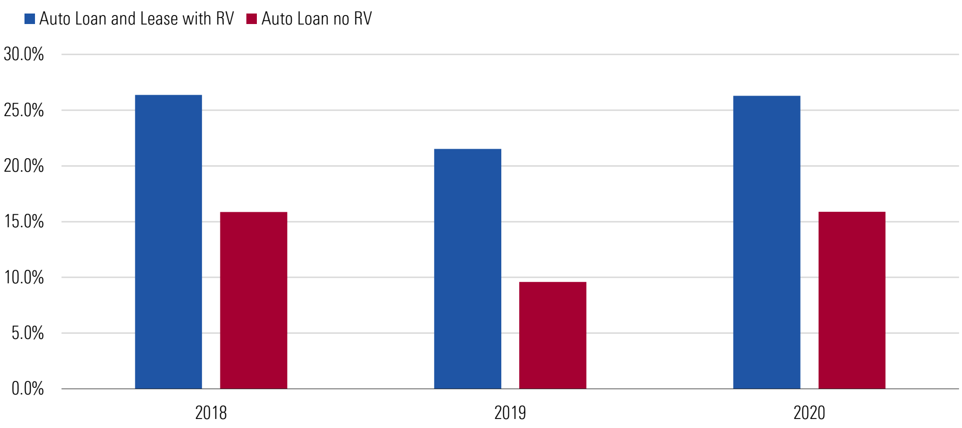


Source: Haver.

DBRS Morningstar considers these shifts to be relevant within its rating analysis of portfolios backed by auto loan/lease receivables. The change in product mix and increase in vehicle values has elevated residual value risk considerations for Auto ABS transactions, surpassing the traditional approach focused on credit risk. As transactions increasingly rely on proceeds associated with residual values, we give particular attention to the underlying performance of used vehicle markets, realisation rates and timings, jurisdictional variances, and corporate governance over the determination of residual values.

Where applicable, the determination of residual value losses is particularly relevant for the analysis of Auto ABS transactions as this is typically the primary driver of credit enhancement. For DBRS Morningstar-rated transactions, higher subordination ratios for the highest rated notes are observed for transactions that have residual value exposure. This is further compounded where transaction structures incorporate pro-rata features as the proportion of receivables affected by market risk increases over time while credit enhancement levels can remain constant. The timings associated with market-related losses therefore become an important consideration within the cash flow analysis.

Exhibit 8 Subordination Ratio of the Highest-Rated Note for DBRS Morningstar-Rated Transactions



Source: DBRS Morningstar.

New Digital Origination Channels

The automotive industry had remained broadly untouched during the dawn of digitalisation, because of the high capital investment required and the one-off decision customers face when purchasing a vehicle. However, times are changing and more customers are starting their journey online and are willing to complete their vehicle purchase there too.

The number of digital channels available to a customer has increased. These include several marketplace platforms and new companies representing online versions of showrooms that focus on delivering vehicles directly to customers' homes. The captive finance company incumbents have subsequently adapted their business models to improve their process towards digitalisation.

DBRS Morningstar considers there to be several consequences from the growth of new digital channels that may drip feed into Auto ABS transactions:

- A focus on customer retention throughout the product lifecycle. Rewards are granted to loyal customers if they take out a subsequent product. This could lead to changes in prepayment behaviour.
- An increase in cross-selling opportunities with finance providers offering additional financial or nonfinancial services to borrowers, including insurance and deposits. While the insurance premiums may be capitalised and form part of the securitised receivable, set-off risk may arise if the underlying obligor is able to apply claims owed by the originator to reduce their own obligation.
- A greater use of automated underwriting platforms and the adoption of pre-scoring models, where customers selecting vehicles or financial solutions online are pre-assessed before being assigned to a specific dealership. This may lead to a broader mix of issuers that target specific risk segments.

New Originators and Portfolios

DBRS Morningstar has observed portfolios from new specialised originators as well as changes to those of experienced originators in new jurisdictions among recent Auto ABS transactions.

DBRS Morningstar expects Auto ABS transactions characteristics to continue to evolve in a number of ways.

1. For transactions where receivables associated with TCM products comprise a significant proportion of a portfolio, residual value risk or market risk increasingly becomes predominant in lieu of credit risk. Structures have subsequently evolved in line with STS regulation to incorporate guarantee/buyback agreements or have capped residual value exposure.
2. Because of the shorter weighted-average life of the underlying product, revolving periods are often used in transactions dominated by TCM products to increase transaction tenors. For DBRS Morningstar-rated transactions, we observe that transactions with revolving periods now outnumber static ones. Whilst the average length of the revolving period has been volatile, DBRS Morningstar still observes two different approaches that are linked to the issuance strategy of an originator: longer revolving periods with lower issuance frequency or no revolving period but higher frequency (which may be linked with separate master type revolving structures).

3. With flexible financing products characterised by shorter contract tenors becoming more popular, alternative structural features could arise in Auto ABS transactions: portfolios may become more dynamic rather than static, where obligors or the underlying vehicles change at a higher frequency during a revolving period. This could lead to rapid changes in obligor and asset concentrations and could lead to volatility in residual value and credit risk exposure.
4. Cash flow analysis for Auto ABS transactions could be affected by these new considerations:
   - Cash flow volatility: Amortisation schedules could become more unpredictable as a result of seasonal variations associated with contract maturities and residual value amounts. This could lead to shorter than expected transaction tenors.
   - Cash flow sensitivities: Risks associated with balloon payments and residual values are often back-loaded and proportionately increase during an amortisation period. This may not be aligned with structures that incorporate pro-rata features that allow credit enhancement levels to remain static for an elongated period. The proportionate increase in the balloon and residual value risk compared with available credit enhancement levels could result in rating volatility, specifically for senior, higher rated notes.
   - The impact of prepayments: The growth of TCM products, specifically in markets such as Spain and Italy, has increased the likelihood of customers settling their outstanding finance contracts early, typically to allow for the origination of a new loan agreement supporting a new vehicle purchase. Prepayments are an important element of DBRS Morningstar's cash flow analysis as higher prepayment levels (1) reduce excess spread (2) may artificially suppress default rates, specifically with regard to the balloon component as customers use the value of the vehicle to facilitate settlement, (3) influence default timings because of a reduction in the weighted-average life of a portfolio, (4) could lead to potential losses for an issuer, in the absence of an indemnity, if the purchase price paid by the issuer is higher than the outstanding principal balance of the loan. This can happen if the discount rate applied upon purchase is lower the actual contractual interest rate.
5. Default timings: Shorter contract tenors with residual value risk exposure may be subject to compressed, front loaded default timings in higher rating scenarios, again depriving transactions of excess spread.
6. Operational risk: As new originators continue to emerge from these new business models, which in most cases are fully digitalised, an increased focus on operational risk may arise. The growth of these new originators can often be rapid and the ability to scale in a controlled manner is critical specifically for entities lacking the operational experience, governance and financial wherewithal of investment-grade companies. Explicit back-up servicing arrangements, which are typically not observed for experienced investment-grade servicers could become more commonplace to address servicing continuity risk.

Our approach to residual value risk for Auto ABS transactions is outlined in our *Rating European Consumer and Commercial Asset-Backed Securitisations* methodology. Residual value loss depends on two factors: (1) the percentage of vehicles returned to the finance company at the end of the lease or loan term (turn-in rate); and (2) the market value of the returned vehicles compared with the contractual residual value at maturity.

We examine a finance company's policy for setting residual values to derive rating-specific residual value loss assumptions for each transaction. In doing so, we assess the embedded losses (representing the residual value risk appetite of an originator), as well as market volatility for the local used car market. External data may also be used to monitor and assess changes in a specific used vehicle market.

We continue to closely monitor the changing European automotive finance environment to incorporate relevant risks into the analysis of Auto ABS transactions. Other relevant areas aside from changes to product offerings and the transition to mobility include: the growth in used vehicle financing, market dynamics affected by alternatively fuelled vehicles, and the changing dealer landscape. These all contribute to the interplay of risks that affect the key performance metrics relevant to Auto ABS transactions such as expected default rates, recovery rates, prepayment rates, and residual value exposure. For further details on the outlook and themes affecting European Auto ABS, please see our *European Auto ABS Outlook - Changing Lanes* commentary.

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