

U.S. Structured Finance Newsletter

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AUTO LENDERS ARE NOT CREATED EQUAL

There are primarily four types of lenders in the auto market: captive finance companies, banks, traditional finance companies and credit unions. For these lenders, their reasons for participating in the auto lending business may differ, which can lead to variances in portfolio composition and, possibly, loan performance.

Captive finance companies were initially set up by auto manufacturers to help dealers sell the manufacturers' vehicles. Although they continue to play this crucial role, their proven profitability has led them to become an increasingly significant earnings source for the manufacturers and a more critical part of their organizations. Banks and finance companies make auto loans primarily to generate positive returns for their owners or shareholders. Credit unions traditionally make auto loans to provide their membership with low-cost financing alternatives.

Captive finance companies typically attract prime credit-quality borrowers who purchase vehicles from manufacturer-branded dealerships. In some ways, the captive finance companies have a competitive advantage because manufacturers may subsidize the interest rates they charge borrowers, thus lowering the rates to more attractive levels. As a result, the loan portfolios of captive finance companies are usually high quality and demonstrate very good performance.

Banks also target prime borrowers as they can offer competitive rates due to their low funding costs. However, this does not preclude banks from participating in the below-prime lending space. Some banks choose to lend across the entire credit spectrum or even concentrate on lower credit-quality borrowers. As a result, the performance of banks' auto loan portfolios tends to vary depending on the bank and the profile of the portfolio.

Traditional finance companies are more likely to concentrate solely on below-prime segments of the auto loan market. This is the case because they typically have limited access to low-cost capital, yet they are often able to provide the specialized skills required to underwrite and service below-prime auto loans. This leads to portfolios that typically have higher losses as a result of the lower credit-quality profile of the obligors, but they also have a higher yield in order to produce a profitable business.

Credit unions traditionally attract direct requests for loans from their membership. Because the funds used to finance the loans are principally from the members' deposits, the credit quality of the loan portfolios is usually higher. Further, because of the strong relationship between the borrowers and the credit union, such loan portfolios are predisposed to perform very well.

As a result of the factors that drive the segments of the auto market in which lenders participate, loan portfolios will take on certain characteristics. It is important for asset-backed securities (ABS) investors to understand these differences and how they affect the credit analysis and performance of auto loan ABS transactions.

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